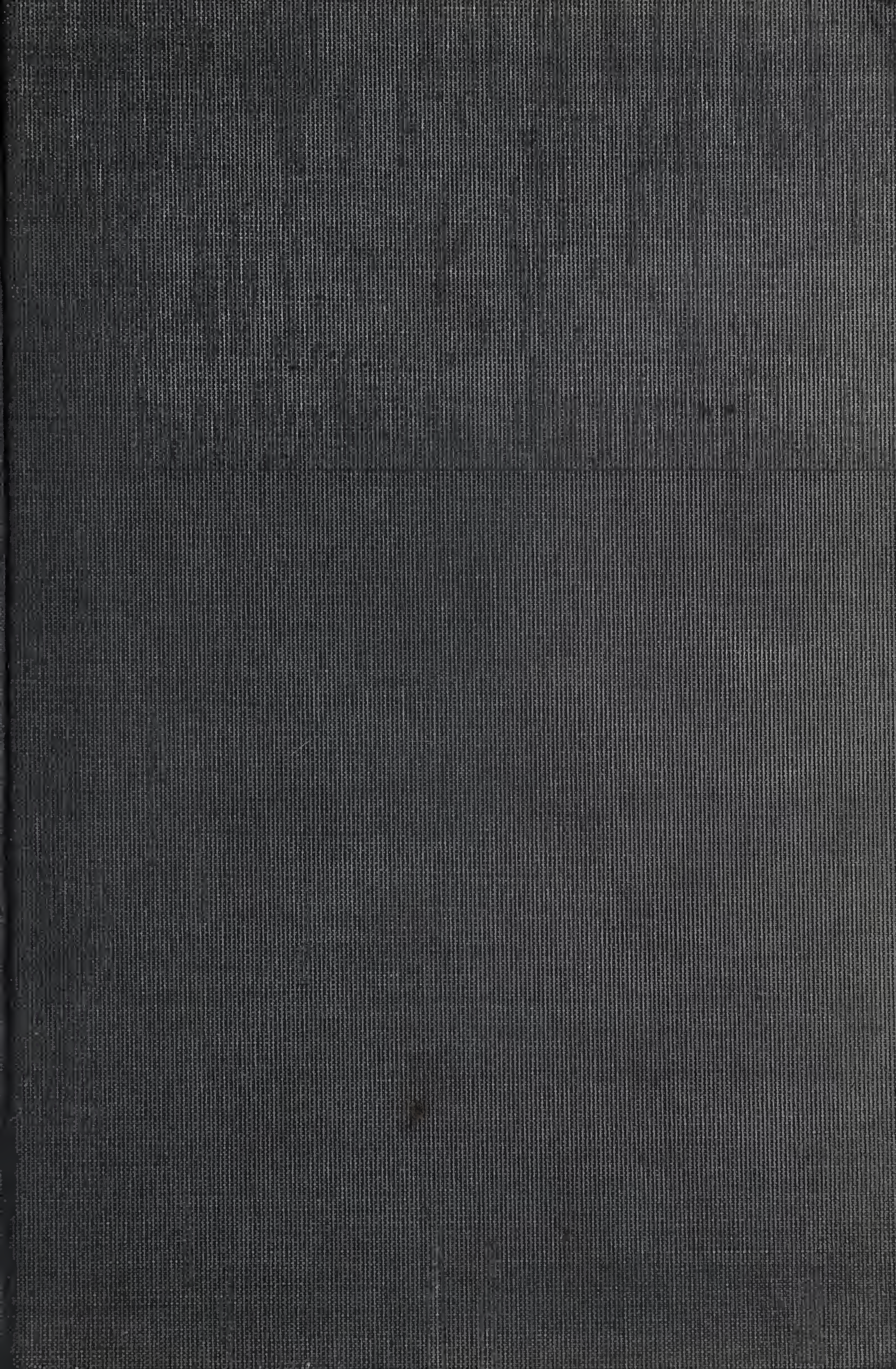

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LEGAL ASPECTS OF CREDIT

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PREFACE

The primary object of the book is to train men engaged in credit work in the phases of the law with which they constantly come into contact, for it is of the utmost importance for credit men to have at least a general knowledge of their employers' legal rights and remedies, as they otherwise cannot serve and protect the interests of their employers to the greatest advantage. In fact, on the score of practical utility, the value of legal knowledge for business men generally is not to be questioned. Most business men who have achieved marked success will admit that they owe it in some degree to a more or less thorough acquaintance with the law. In like manner the success of the credit man depends in a considerable measure upon his knowledge of the particular branch of the law relating to his chosen field of work.

While a study of the information contained in this volume will not enable the credit man to dispense entirely with professional legal advice, it should give him a sufficient grounding in certain phases of the law to enable him frequently to get proper legal redress without incurring the expense of consulting an attorney. Consequently, particular pains have been taken to present the technical phases of the subject in as simple a manner as possible.

As supplementing its main purpose, the book also aims to give a simple but fairly thorough exposition of the fundamental principles involved in credit-granting. Thus, though designed primarily for credit executives, it may also be used to advantage by the younger men of credit departments. Finally, the book being partly the outgrowth of a course of university lectures, should serve helpfully as a reference work for students of commerce in the various schools, colleges, and universities.

Many sources of information were utilized in the compilation of this volume, inasmuch as it has necessarily involved a careful consideration of what has been written by other writers on the various aspects of the subject, and the author has endeavored to give proper credit throughout the book wherever material of any consequence has been utilized.

S. F. B.

New York University
December 15, 1922.

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Legal Aspects of Credit

INTRODUCTION

FUNCTION OF CREDIT AS A SUBSTITUTE FOR MONEY

Before proceeding with the discussion of the principles on which the extension of credit is based, it is only fitting that we should first consider briefly the manner in which credit functions in the commercial world as a substitute for money. This is no mean task, as no less an authority than the eminent economist, John Stuart Mill, has stated that "the functions of credit have been a subject of as much misunderstanding and confusion of ideas as any single topic in Political Economy, due not to any particular difficulty in the theory of the subject, but to the complex nature of the mercantile phenomena arising from the forms in which credit clothes itself."

"As an example," continues Mr. Mill, "credit has a great, but not, as many people seem to suppose, a magical power; it cannot make something out of nothing. How often is an extension of credit talked of as an equivalent to a creation of capital, or, as if credit actually were capital. It seems strange that there should be any need to point out that, credit being only permission to use the capital of another person, the means of production cannot be increased by it, but only transferred; that is, if the borrower's means of production are increased by the credit given him, that of the lender are correspondingly diminished, as the same capital cannot be used as such both by the owner and also the person to whom it is lent."

But though credit is never anything more than a transfer of capital from hand to hand, at interest, it is generally, and logically, a transfer to hands more competent to employ the capital efficiently in production; and capital thus circum-

stanced forms a large portion of the productive resources of any commercial enterprise, or community.

To illustrate, suppose A, B, and C have formed a company for the manufacture of shoes, into which each has put $10,000. The company sells D, a retailer, a bill of goods amounting to $200, terms 30 days net. Of the $30,000 capital, let us assume $8,000 was invested in manufacturing equipment, $8,000 in raw material, $2,000 in advertising, and $4,000 in cost of production; the remaining $8,000 constituting a reserve for current running expenses. In other words, $30,000 cash capital is now represented by the plant equipment, public knowledge of the enterprise, and the manufactured product (so many pairs of shoes). So when $200 worth of shoes is shipped to D the company is parting with a fractional share of what now represents its $30,000 capital; that is, it is practically loaning D a portion of its $30,000, or, to put it in still another way, it is transferring the use of approximately $200 of its capital to him for 30 days. Of course, the sale will actually represent somewhat less than $200 of the company's capital; otherwise it would not be operating at a profit. D in turn will probably realize at least $250 on the sale of the shoes, or $50 on the use of the capital loaned to him, before making a repayment of the loan at the expiration of the 30 days.

The foregoing thus sets forth in a general way the true relation, or function, of credit to the productive resources of a mercantile enterprise. We may, therefore, summarize our conclusions by defining credit as nothing more than a process whereby the use of capital is transferred from one party to another, measured in amount by the recipient's power to borrow on the one hand, and the confidence reposed in his paying propensities on the other. It is also significant to note in this connection the fact that the word "credit," implying faith or trust, is a direct derivation from the Latin word *credo,* meaning, "I believe."

PART I

TYPES OF BUSINESS ORGANIZATIONS AND THEIR LEGAL LIABILITY

CHAPTER I

THE SOLE PROPRIETORSHIP

Defining Credit

The fact that there is such a great variance to be found in the numerous definitions of credit is not to be attributed to any lack of knowledge concerning the fundamental concept with which we are dealing, but rather to the fact that the general term "credit" is sufficiently broad in scope to permit of its being construed differently when the subject is considered from different standpoints. In most instances, however, it will be found that whatever difference exists is more a matter of form and use of words than of substance; in that the definitions all agree to this extent—the extension of mercantile credit necessarily involves the acceptance of a buyer's promise to pay in the future in return for a present sale and delivery of goods by the seller.

Whether a seller is justified in parting with his goods in return for such a promise to pay for them at some future time will depend largely upon two factors:

1. The amount of faith he has in the buyer's ability to carry out his promise—his confidence in the buyer's future ability to pay.
2. The extent to which he can actually hold the buyer legally responsible for his promise in the event he fails to fulfil it.

Basic Types of Business Organization

As a condition precedent to the determination of the extent to which a seller of merchandise can actually hold a buyer legally responsible for his promise, or, in other words, to the

determination of one's legal rights and remedies arising out of the sale and contracts to sell goods, it is necessary to know the type of business organization with which you are dealing. This is because there are, as we shall see, various forms of organization by means of which business may be transacted, and what is of particular significance to a credit man is the fact that the legal liability of the interested parties may vary in both its nature and extent in accordance with the form of the organization in which they are interested. For this reason a preliminary discussion of the more important features of these forms of business organization and their respective legal liability is not out of place.

Throughout the world, wherever business enterprises are carried on, there are to be found three basic forms in which the ownership of the enterprises is held:

1. The individual owning outright his own business and usually managing it himself. This constitutes what is termed "the sole proprietorship." The simplicity of this form does not necessarily imply, however, that it is applicable only to a small business.
2. A group of two or more owners working together and conducting the business as co-owners for their joint profit under some form of partnership agreement.
3. The impersonal owner—the corporation—serving as an intangible intermediate legal entity between the business and the individuals who have various kinds and degrees of claims upon the business.

Other Types

In addition to these three *basic* forms, there are three other forms of business organization which are sometimes, though not so frequently, used in the conduct of business enterprises. These are the limited partnership, the joint-stock company, and the unincorporated association.

Definition of Sole Proprietorship

The first of the three basic forms of business organization—the sole proprietorship—is the simplest and most numerous. A sole proprietor is one who conducts his business in person or through agents without admitting anyone else to share the profits. He alone owns the property in the business, and he alone decides the policy to be pursued in its management. He may, of course, have agents to whom he entrusts important matters, but they are his employees and are responsible to him alone.

There are no special laws affecting the rights of an individual to engage as a sole proprietor in whatever business he may desire, so long as such business is conducted within the scope of the general law or statutes. He may conduct such business as he sees fit, so long as he is mindful of his legal relations to the government and the individuals or companies with which he does business. In other words, the sole proprietor of a business has the broadest opportunity to do as he pleases. He may even conduct the business under an assumed name, either that of an individual, firm, or company, if he complies with the law.

Statutory Restrictions

Statutes, however, generally require that he shall file in the office of the clerk of the county court in which the business is conducted, a certificate setting forth the name under which the business is conducted together with the name and correct post office address of the party or parties conducting it.

The purpose of the state legislatures in enacting such statutes is nowhere better expressed than in the case of Sagal v. Fylar:[1]

> The remedial purpose of the statute manifestly was that the public should have ready means of information as to the

[1] 89 Conn. 293.

> personal or financial responsibility behind the assumed name. It was for the protection of those who might deal with or give credit to the fictitious entity. It absolutely was not to provide means by which persons having received a benefit from another should be enabled to retain it without compensation and to repudiate any agreement for compensation.

The statutes are usually penal in their nature and provide a fine or imprisonment for violation. But in some states, notably California, Colorado, Kentucky, Massachusetts, Oklahoma, Oregon, and Pennsylvania, no action upon contract can be maintained by an individual or partnership which has failed to comply with the statutes. In Arizona, Indiana, Michigan, Minnesota, Montana, South Dakota, Vermont, and Washington, failure to file the required certificate can be cured, provided the certificate is filed prior to the institution of suit, even though the certificate was not on file at the time the cause of action arose.[2]

Legal Liability

The law does not recognize any distinction between the sole proprietor of a business as a legal entity, and the same party as a private individual or social being. The debts of the business are the proprietor's debts, regardless of his other outside interests. In other words, he cannot legally separate his personal property from that devoted to his business. When creditors sue, they sue the individual, and if the assets of the business are not sufficient to satisfy the judgment, such judgment creditors may have recourse to any other assets which he may own outside of the business.

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[2] For a complete digest of the various state statutes, see Credit Men's Manual of Commercial Laws.

CHAPTER II

PARTNERSHIPS AND THE UNINCORPORATED ASSOCIATION

Definition

A partnership is a legal relation existing between two or more competent persons who have agreed to combine their labor, property, or skill for the purpose of engaging in any lawful business for their joint profit. Fundamentally, there is no essential difference between the sole proprietorship and the ordinary partnership, except that in the latter case there is a group of owners instead of one individual owner.

There are several different forms of partnership relation which may be entered into. They are usually classified as:

1. General or ordinary partnerships
2. Limited partnerships and
3. Joint stock companies

depending upon the nature of the partnership agreement entered into between the parties. But all three classes represent types of organizations which are based on a contractual relation, either express or implied, entered into between parties competent to contract.

1. General Partnerships

This is the most common type of partnership organization. Such a partnership may be created for carrying on any lawful business, and as a general rule whatever the members could do acting individually may lawfully be done in partnership.

No particular formalities are required in the formation of the general partnership, and an express agreement is not essen-

tial. All that it is necessary to prove is that the partners have agreed to do business and to share the profits as proprietors. If that is proved they are partners, whether they meant to be or not. Any statement or reservation in such an agreement to the effect that they shall not be partners merely affects their relation to each other, but as to outsiders or creditors they are partners.

The United States Supreme Court has laid down this test to determine whether or not a partnership relation exists:

1. Was there a business in common?
2. Did the parties receive a share of the profits from that business as principals?

Articles of Copartnership

Where the terms of the agreement are expressed, they are generally embodied in what are termed "articles of copartnership." Inasmuch as the partners, or contracting parties, may agree upon any terms or arrangement they may choose, no matter how unusual, so long as it does not violate the law, such articles of copartners should always be closely scrutinized, when possible, for the purpose of ascertaining the true nature of the undertaking and the extent to which each of the contracting parties is interested *as between themselves.* For example, suppose the agreement provided that all the partners were to share profits equally, but certain phases of the management were to be vested in a particular partner or partners. The credit man would be interested in knowing this in calculating the firm's prospects of success. Many credit men have found out to their sorrow that partnerships are many-sided and not all they might be.

Who May be Partners

Any person capable of entering into contract may be a partner. An infant (meaning a person under legal age) may be a partner, but his contract of partnership is voidable and

he may interpose his infancy as a defense against personal liability. While such a partnership relation exists, he has all the rights of a partner. And even though he later disaffirms his contract of partnership, his interest in the firm property remains liable for partnership debts. In fact, this is the extent of an infant partner's liability after his partnership agreement has been disaffirmed.

A corporate enterprise cannot be a partner. Two or more firms may form a partnership. Likewise a firm and an individual. A partner may also form a subpartnership with a third party as to his particular interest.

Nature of Partnership

What constitutes a partnership is a question of law. Whether the facts in a given case constitute a partnership is a question of fact to be proved by evidence of the articles of copartnership, books, business conduct, or individual testimony.

Where a partnership relation is created by an expressed or implied agreement, and is dependent upon the intention of the parties, and where the element of sharing profits and losses is present, it may be said to be strong but not necessarily conclusive evidence that the parties have united as principals for their joint profit. In other words, where a concern employs an agent to get contracts and agrees to pay him a share of the profits instead of a salary, and, in order to make him cautious in choosing the parties with whom to contract, further agrees that he is to share the losses—he is not a partner because it was never intended that he should thereby become a coprincipal in the business. Likewise, one who receives a share of the profits in repayment for an advancement made to the firm capital is not a partner.

Suppose the agreement provides for the sharing of profits but not losses. If one party furnishes all the capital and the other shares in the profits as compensation for his services, such an agreement would not constitute a partnership; but if

both contribute and are to share the profits as principals and agents for one another, they are legal partners. In other words, the parties must own the business in common to be legal partners.

The Firm Name

In the absence of statutory provisions any name may be used under which to conduct the business, but unless authorized by statute, legal action cannot be maintained either by or against the partnership in the firm name—the action must be brought in the individual names of the partners. And if there are three partners and only two of them are sued, the action is subject to a plea in abatement on the ground that one of the partners was not joined in the action. Otherwise the judgment will be taken against the two only and will not bind the *individual* interest of the other partner.

Firm property, personal or real, may be held in the name of one partner, but a partnership cannot take or hold real property in the firm name. The conveyance must be made to the individual members of the firm.

Suppose, however, that land is found to be held in the name of one partner? If purchased with partnership funds, used for partnership purposes, and carried on the books as firm property, it is firm property and the partner holds it subject to a resultant trust in favor of the firm.

One partner cannot sue the firm at law because he would necessarily be both plaintiff and defendant to the action. Nor, for similar reasons, can the firm sue one of the partners. A court of equity is the proper tribunal for the settling of partnership controversies, generally upon a request for an accounting.

Manner of Accounting

In distributing the proceeds upon dissolution, the losses are to be paid first out of the assets, excluding capital. Next,

out of the capital, and finally, by recourse to the partners individually.

The assets of the firm should be applied as follows:

1. In paying liabilities of the firm to non-partners.
2. In paying each partner what is due him from the firm for advances, as distinguished from capital.
3. In paying each partner ratably the amount due him in respect of capital.
4. The residue to be divisible as profit.

As a general rule, and in the absence of an express agreement to the contrary, partners bear losses in the same proportion in which they share profits, even though one has contributed the entire capital.

Dissolution

The dissolution of a partnership is defined in the Uniform Partnership Act as the "change in the relation of the partners caused by any partner ceasing to be associated in the carrying on, as distinguished from the winding-up, of a business." The effect of the dissolution is to terminate the agency relation existing between the partners.

To say a partnership has been dissolved is to say that the relation which subsisted between persons who were carrying on a business in common with a view to profit, has been terminated. As soon as this relation has been discontinued, the powers of the associates which are conferred by the partnership relation, are withdrawn. Consequently, if new business engagements are entered into, they are binding upon the individuals who have made or have actually authorized them, but upon no others.

If, upon dissolution, the partners are unable to agree upon the manner and process whereby the business is to be liquidated, it is competent for any partner to apply, in case of necessity, for a receiver and have the affairs of the partnership wound up under the direction of the court.

Termination of the Partnership

The termination of a partnership does not mean that the business is to be immediately discontinued but that the respective rights of the partners are to be determined as of the time of termination. It may be brought about by:

1. Lapse of the time specified.
2. Accomplishment of the object for which it was organized.
3. Consent of all parties.
4. Withdrawal of a partner.

If the partnership was created for no definite length of time—a partnership "at will"—it may be terminated by any partner at any time without incurring any liability. When created for a definite period, each partner has the power to withdraw and terminate the right of the other partners to bind him further, but in so doing he subjects himself to an action for damages.

5. Death of a partner.

Upon the death of one partner, title to all firm property and assets vests in the other partners and it is their duty to close up the business and render an accounting to representatives of the deceased's estate in order that the value of the interest of the deceased partner may be determined. As to realty, the legal title vests in the surviving partner and the heir of the deceased partner jointly, but the surviving partner can compel the heir to join in a deed of conveyance if the surviving partner sells the property in winding up the business. And this he may do without the consent of the deceased partner's legal representative. The business may be continued with the consent of the deceased's beneficiaries, but upon dissolution no new obligations may be incurred by the firm unless incidental to the closing up of the business. In case of the death of a partner, a firm creditor is obliged to exhaust his remedy

against the surviving partners before he can collect from the decedent's estate.

6. Bankruptcy of a partner or the firm.
7. War between nations represented by partners.
8. Insanity or serious misconduct on the part of one partner which permits the other partner or partners to apply to the court for a dissolution.

In the absence of statute, no partner has the right to insist that firm creditors shall exhaust the firm assets before having recourse to the partners as individuals. In other words, although it is necessary to sue them all jointly, once a judgment has been obtained, you can collect from any one partner separately and individually. In such cases, where execution is satisfied against the personal assets of one of the partners, the partner obtains a lien on the firm assets and partnership property. This is the general rule, but there are exceptions to it. In New York, for instance, firm assets must be exhausted before the private property of the partners can be taken under a judgment.

Legal Liability

Each general partner is an agent for the partnership in the transaction of its business and has authority to do whatever is necessary to carry on the business. He acts as principal for himself and as agent for the other partners. Consequently, each general partner is personally liable to third parties for all the partnership obligations. For instance, a note payable to the firm may be indorsed in the firm name by one of the partners. In such case the firm signature is equivalent to the individual signature of all the partners. For the same reason a partner can mortgage or transfer the entire firm property to pay firm debts, and such transfer cannot be attacked by creditors if the firm was solvent at the time of the transfer. In some states, as Ohio, a partner has implied power to make

a general assignment; whereas in others, as New York, he has no such implied power unless the other partners are absent or inaccessible.

In one sense the legal liability of copartners is not only joint but several, because if a judgment is obtained against all, execution may be issued against the individual interest of any one of them. (In New York, where only one partner is served with process, the judgment is binding on all, but it binds only the firm assets and the individual assets or property of the partner served.)

The old view was that partners were tenants in common and each held an undivided portion of the firm assets or property. The modern view, however, is that a partner's interest is simply a right of action to the surplus remaining after the firm debts are paid. Consequently, an individual creditor of one of the partners can acquire no greater right in the firm property. A partner can execute a valid mortgage on partnership property to secure his individual debts, but such a mortgagee obtains only a lien on whatever surplus remains after the affairs of the firm are settled and his equity in the business is thereby ascertained. And it has been held that if a sheriff attempts to levy on partnership property to satisfy a judgment against a partner's individual property, he is guilty of conversion. The sheriff may take possession of the property and can be dispossessed only by the partners giving bond—such possession of the sheriff to continue in effect until an accounting has been made—but all that he may sell is the particular partner's interest in the firm property as determined by an accounting.

Rights and Remedies of Partnership Creditors

Firm creditors have a right to have the partnership property applied first to the payment of the partnership debts. An individual creditor of a partner cannot attach the partner's interest in the partnership property to the prejudice of the partnership

creditors. After the firm creditors are paid, the separate creditors of a partner are entitled to any surplus belonging to him.

The weight of authority is also in favor of the converse of this rule, namely, that the separate creditors of a partner are entitled to be paid first out of his separate estate. After the separate creditors are paid, the partnership creditors are entitled to the surplus. An exception to this general rule is: "Where there is no living solvent partner and no firm assets, the firm creditors share equally in the individual assets with the individual creditors."

In other words, the principle underlying the legal liability of partners may be briefly stated as follows: The joint estate is applied to the payment of joint debts, and the separate estate to the payment of separate debts, any surplus from either estate being applied in settlement of the other, and vice versa, if necessary. But this applies only when there are partnership assets. If there are no partnership assets, and no living solvent partner, the firm creditors share equally with the individual creditors.

Exemption statutes apply to individuals only, and a partner is not allowed any exemption as a partner.

A partner, while he has implied power to buy and sell partnership property, has not an implied power to use the firm property to pay his own debts, and the firm may recover such property even from an innocent purchaser for value without notice. It is not a question of knowledge on the part of the one who receives it, but of the authority of the partner to make such transfer. But if the innocent purchaser for value reconveys it to a third party, the third party can keep the property, the theory of the distinction being that a creditor is not a purchaser for value without notice. In other words, the law makes a distinction between one who received the property in payment of an antecedent debt and one who receives it for value.

Rights of Creditors When Not Notified of Change in Personnel

The formation of a partnership results in creating not only a relationship between the partners, to which the law attaches certain rights and liabilities, but also between the partnership so created and third persons, or creditors, who deal with it as a business entity. If there is any change made in the personnel of the partnership, it would seem only right and proper that the creditors of the firm should be promptly notified accordingly. In fact, such notice is required to two classes of creditors: (1) to those who have extended credit to the firm, and (2) to those who have not extended credit to the firm prior to the change in personnel but do so subsequent thereto.

1. Creditors Who Have Extended Credit to the Firm Prior to the Change. In this case the rule has been laid down:

> To relieve a retiring partner from liability for subsequent transactions in the firm name, notice of the dissolution must be brought home to the persons giving credit to the partnership. If, in any way, by actual notice served, or by seeing the publication of the dissolution, or by information derived from third persons, the party at the time of the dealing is made aware of the fact that the partnership has been dissolved, the contract will not bind the firm.

In other words, a retired partner is liable to a creditor for firm debts if he has permitted the other partners to use his name and "no notice was given."

Professor Mechem says:

> A common way of giving the notice is by personal communication, or by letter or circular addressed to all persons who have in the past extended credit to the firm. Mailing the notice, properly addressed, raises a presumption of its due receipt, but the presumption is not conclusive, and if rebutted, actual receipt must be shown. Mere publication in a newspaper is obviously not enough; it must appear further that the party to be notified actually saw it or otherwise knew of it.

2. Creditors Who Extend Credit to the Firm Subsequent to the Change. As for the second class of creditors, Professor Mechem states:

> In the case of creditors who did not know of the partnership personnel prior to its dissolution, no notice at all is necessary, upon the ground that as they did not learn of the existence of the partnership until after it had actually been dissolved, they could not have been misled by prior appearances, and therefore they could have no reason for holding it liable. But where the creditor knew of the partnership but had not dealt with it prior to its dissolution, a "general" notice is enough, and this notice may be given in a variety of ways, though publication for a reasonable period in a newspaper of general circulation at the place where the partnership business is carried on, is deemed the most effectual and appropriate.

Where a partnership is dissolved or a known member of the firm retires under circumstances requiring notice, then, until notice of the dissolution or retirement has been properly given, the power of each partner to continue to bind the others by contracts within the scope of the business made with creditors entitled to notice, remains unimpaired, although as between the partners themselves his authority may have terminated.

2. Limited Partnerships

Two or more persons may form what is known as a "limited partnership" for the purpose of engaging in any lawful business except banking and insurance. Partnerships of this nature, however, can be organized only when permitted by statute. Such a statute has been enacted for this purpose in a majority of the states.

The purpose of creating a limited partnership is to permit the formation of partnerships in which some of the partners who conduct the business shall have general personal liability, while others, the "special partners," who take no part in the management, may contribute a given amount and assume no further liability.

In other words, the business of such limited partnerships is carried on by the general partners, who alone represent the firm. In fact, if a special partner participates in the management he becomes liable as a general partner. Contracts must therefore be made by and in the name of the general partners, and suits must be brought by and against them alone.

This type or form of business organization still continues in favor throughout the British Empire, but the movement has not gone very far in the United States because of the superior advantages of the corporate form.

Organization of Limited Partnership

In most states special statutes require, for the formation of a limited partnership, the execution of a certificate, to be filed and recorded in the clerk's office of the county in which the principal place of business is located. It sets forth:

1. Name of firm under which the business is to be conducted.
2. General nature of the business to be transacted.
3. Names, and whether of full age, of all general and special partners.
4. Amount of capital contributed by each special partner.
5. Time at which the partnership is to begin and end.

The names of the general partners must, as a general rule, appear in the firm name, and some of the state statutes also require that the word "Limited" be added. Others require the display of a sign in a conspicuous place outside the place of business showing the names in full of all partners and indicating which are general and which are special partners.

Legal Liability of Limited Partnership

It has been held that unless there has been at least a substantially full and exact compliance with the statutory provisions, the special partners will be liable as general partners to third persons, or creditors. In other words, a limited

partnership that has not so complied with the statutory requirements is not a limited partnership in fact, but a partnership in which all the partners are liable as general partners.

The members of a limited partnership, either before or after insolvency, are liable for the partnership debts in the same manner and to the same extent as general partners; and their creditors are entitled to recover judgments against them with a view to satisfying their judgment out of either or both the individual or partnership assets, subject, of course, to the restricted liability of the special partners.

Interest in Partnership Non-Transferable

In the general or ordinary partnership, all of the members of the firm are co-owners of the whole of the partnership property. Such being the nature ascribed to a partner's share, it is clear that he has no individual title to any specific part or portion of the partnership property, and consequently can neither sell nor assign any part or portion of it as his own.

A partner may, however, transfer such interest in the partnership as he has, but the transfer of his interest does not operate to work a substitution of the grantee as a new member of the firm, but has the effect of dissolving the partnership, leaving to the grantee the right to the value of the share thus acquired as determined by the final accounting. The reason for this is that the fiduciary relation that exists between partners demands mutual trust and confidence, and the right to choose one's own partners is properly regarded as one of the most important characteristics of a partnership.

3. Joint-Stock Companies Defined

An exception to this rule of dissolution exists in the case of a joint-stock company, which may be defined as "an ordinary partnership except that, by the original contract of the members, it is agreed that any member may transfer his share and that his transferee shall accordingly be received into the part-

nership." In other words, it is merely a partnership with transferable shares, wherein the holders may transfer their shares or interest exactly as stockholders do in a corporation.

These companies constitute an abnormal kind of partnership, possessing some of the characteristics of a corporation, and are a form of business organization that was at one time popular (particularly throughout the British Empire) but which in this country is now practically obsolete. (The Adams Express Company is a joint-stock company.) While joint-stock companies possess certain of the characteristics of a corporation, they are not such because:

1. The debt of a corporation is its own debt, whereas the debt of a joint-stock company is that of its members.
2. A joint-stock company derives authority for its existence from a contract of individuals, whereas a corporation derives authority for its existence from the sovereignty of the state.

The personality of the members, so important in the case of the general partnership, ceases to be important in such an organization, for usually they are large partnerships and by mutual consent the management of the business is generally vested in and confined to a few persons who may or may not be shareholders.

The main points of difference between a joint-stock company and a partnership may be said to be:

1. The transfer of shares or the death of one member does not dissolve the campany.
2. Management of the business is vested in a board of directors or selected officers.
3. The right of one member of the company to bind the company does not exist as in a partnership.

Legal Liability of Joint-Stock Companies

Joint-stock companies are similar to ordinary partnerships with respect to legal liability in that each member, or share-

holder, is personally liable for the debts and obligations of the company so long as he remains a shareholder. In other words, the shareholder's liability for company obligations is that of a general partner, and it cannot be limited by the articles of association. But a creditor must first exhaust his rights and remedies against the company and then collect the deficiency from the members. There is a distinction, however, to be made between the liability of an outgoing and an incoming shareholder.

The liability of an outgoing partner to creditors for existing debts is not usually affected by the agreement provision for the transfer of shares, and a shareholder cannot escape liability for existing obligations of the company by merely transferring his share. This is not true, however, as to obligations incurred subsequent to his withdrawal, provided proper notice has been given.

The liability of an incoming shareholder to existing creditors is usually the same as that of a general partner, and he takes such share subject to all rights and liabilities attaching thereto. It therefore follows that a creditor would be afforded the option of suing either the company personnel as it existed at the time the indebtedness was incurred or as it existed at the time the suit was brought.

However, in the ten states[1] in which the Uniform Partnership Act has been enacted, the liability of an incoming partner is modified to the extent that he incurs no personal liability for past debts, but that his interest in the partnership property is subject to such debts.

Statutory Enactments

Such companies may exist without statutory authority, although in a number of states statutes have been enacted providing for their creation and regulation. In such cases the

[1] Alaska, Illinois, Maryland, Michigan, New York, Pennsylvania, Tennessee, Virginia, Wisconsin, and Wyoming.

right to sue and be sued in the firm name is generally conferred as a matter of convenience, as the number of partners is likely to be greater than in ordinary partnerships. But in the absence of such statutory enactment all the members must join in any action by the company, and as many as the creditor wishes to hold must be joined in an action against the company.

Unincorporated Associations and Societies

Such organizations are not statutory entities, but are formed by mutual agreement and derive their power and unity of organization usually from an adopted constitution supplemented by enacted by-laws. The object and purpose of such organizations is usually that of rendering some special service to the members or to the public, and not for pecuniary profit. If such an organization were actually engaged in carrying on a business for profit it would ordinarily be deemed a partnership.

The most common types that the credit man has to deal with are the unincorporated social clubs, hospital associations, friendly societies, fraternities, and church and co-operative associations.

Legal Liability of Unincorporated Associations and Societies

Such bodies are not engaged in business, are not organized for pecuniary profit, and are therefore not partnerships within the legal significance of that term. Consequently the legal liability of a member of such an organization is not to be determined by the law of partnership, but by the law governing the relation of principal and agent.

Authority to bind the organization is usually vested in certain selected officers or a board of trustees or some agent appointed by them for a particular purpose, e. g., the steward of a club, and no single member has authority to bind the association merely by virtue of his membership.

The liability of the members for debts and obligations incurred by the organization is the same as that of partners, provided the indebtedness was incurred within the scope of the organization's purpose and by an authorized representative or agent—those members and those only being liable as principals who have expressly or impliedly authorized the acts to be done in their behalf, or who have subsequently ratified them. And if the obligation is not incurred in such manner, only the contracting members may be held, unless their action was later formally ratified by the organization.

Just as care should always be exercised when dealing with minors, similar care should be exercised when dealing with clubs and associations. Be sure you know where the responsibility really rests, and whether the party you are dealing with has authority to obligate the other members.

CHAPTER III

THE CORPORATION

Definition

When so large a proportion of the business of the world is carried on under the corporate form of organization, it is absolutely essential that the credit man have at least a general knowledge of the organization of the corporation, its methods of acting and carrying on its business, and more particularly of the responsibilities and liabilities of the corporation itself, its officers, directors, and stockholders.

A corporation is an artificial person created by statute law and endowed with many of the legal capacities of individuals, such as the power to take, hold, and convey property, make contracts, sue and be sued, and the like. Chief Justice Marshall defined a corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law." Being a mere creature of the law, it possesses only those rights which are conferred upon it by the law as set forth in its charter.

Test of Corporate Relation

Private business corporations—those with which we are solely concerned—are intended to enable a number of interested parties to unite their capital in an enterprise with two important results: (1) the power to transfer their shares to other holders without affecting the business; and (2) the power to limit their personal liability for the debts, contracts, or torts, of the corporation. A general partnership accomplishes neither of these results. A special partnership accomplishes the second, but not the first. A joint-stock company accomplishes the first, but not the second.

Regardless of the form or manner in which a business may be conducted, the true test as to whether it constitutes a corporate or partnership relation among the interested parties lies in the source from which the liability of the parties arises. If the liability is the result of their entering into a contract, it is a partnership—general, special, or joint-stock company; whereas if the sole source of the liability is a state law or statute, it is a corporation. In other words, the only thing necessary to create a corporation is the intent of the state legislature to that end. And the three so-called "requisites" of a corporation—perpetuity, limited liability, and transferability of shares—are not requisites, but merely characteristic features of a corporation, inasmuch as they may be possessed by special forms of partnerships.

Organization—The Charter

The charter is the very basis of corporate existence—its "birth certificate"—which serves to bring the corporation into being as a business organization. Formerly charters consisted of special laws enacted by the legislatures creating specific corporations. It is now the policy of the law, however, to enact *general* corporation laws with which the incorporators must comply, and when they do they are entitled to their charter as a matter of course and right. When the incorporation is effected through the medium of such a general enabling act, a certificate of organization or association is granted, which, together with the provisions contained in the enabling act, constitute its charter.

The procedure to obtain a charter under such laws consists in filing a certificate setting forth the facts required by law, which vary in different states and include the following:

1. Name of the proposed corporation.
2. Amount of its capital stock.
3. Number of shares into which it is to be divided.
4. Par value of such shares (if any).

5. Objects of the corporation.
6. Location of its principal office.
7. Names of the incorporators.

This certificate is filed in the office of the Secretary of State and as a rule a copy of it must also be filed in the recorder's office in the county in which the principal office of the corporation is located.

Who May Incorporate

As a rule, any natural person who can enter into a binding contract relationship can properly act as an incorporator. This excludes minors, persons of unsound mind or otherwise incompetent, firms, corporations, or anyone acting in a representative capacity. It does not exclude married women, who frequently act as incorporators.

The minimum number of incorporators and the percentage of state residents required are prescribed by statute and vary in the different states. The Ohio statute requires five incorporators, three of whom must be state residents, whereas in New Jersey none of the incorporators need be either a resident of the state or a citizen of the United States.

The function of the incorporators is to serve as the active agents in bringing the corporation into existence. They apply for the charter, subscribe for stock, call and conduct the first meeting, and attend to all other legal requirements incidental to incorporating the business up to the point when it is actually ready and prepared to function and transact business as a corporate entity.

Oftentimes, as a matter of convenience, or because they do not wish to disclose their identity, the real parties in interest will have what are called "dummy incorporators," or persons without any material or permanent interest in the enterprise, to carry out the technical duties of incorporators. In such cases the dummy directors execute the charter and organize the corporation, usually subscribing for the smallest number of

shares required by statute. They later assign their stock and resign any official position they may hold in the corporation in favor of the real parties in interest. When properly conducted, such means of incorporating is entirely legal, and is the method pursued in the formation of almost all of the larger corporations. The United States Steel Corporation was incorporated by three dummy incorporators, each of whom subscribed for 10 shares of stock out of a total capitalization of $3,000. As soon as the organization as a corporation was completed, the incorporators were retired and the capitalization was increased to $1,100,000,000.

Corporate Purposes

Whereas a sole proprietor or general partnership may engage in any form of business not prohibited by law, a corporation may do only those things and engage in such business undertakings as are set forth in its charter. In other words, a corporation is a creature of limited powers. Things otherwise legal but not within the scope of its charter are entirely beyond its powers, or *ultra vires.* Such *ultra vires* contracts cannot be enforced against others, but usually bind the corporation. Directors and officers may make themselves personally liable either to the corporation, its stockholders, or to third parties for involving the corporation in such unauthorized transactions.

System of Stock Capitalization

The capital stock of a corporation is divided into units called "shares," which are issued to subscribers of the stock according to their respective interests. These shares have a par or face value determined by the proportion which the unit bears to the entire capital stock. Thus if the entire capitalization amounts to $100,000 and only 1,000 shares of stock are to be issued, the par value of each share is $100. However, the capital stock may be divided into as many shares as is con-

sidered desirable when obtaining the charter, but in practice it is customary to have shares of the par value of $5, $10, $50, or $100. In all states the maximum amount of capital stock that may be issued is fixed by and set forth in the charter. The amount may later be increased or diminished by charter amendment.

Common and Preferred Stock

Often the classification of shares into "common" and "preferred" is set forth. Preferred stock is that to which some preference has been given over other stock of the same corporation, as to participation in profits or dividends, and often in the corporate assets in case of liquidation. If there is no such distinction to be made in regard to these two features, the stock of a corporation is all common stock or simply "capital stock."

In a number of states, laws have been passed providing for the incorporation of stock companies with shares of unspecified or no-par value, each of such shares merely representing a fractional interest in the profits and assets of the corporate enterprise. There is always a natural human tendency to associate the par value with the true value of the stock, and it was to escape this irresistible tendency that the unvalued share was devised, by forcing the public to investigate the real value of the shares.

Fundamentally, there is no real difference between par and no-par shares—the real value of the share is the same whether its par value is $10 or $100, or nothing at all. In other words, the real or market value of stock is not the same as its par value except by accident. It may be either greater or less. The real value of the share is that for which it sells in the open market, and that is determined by the public's appraisal of its worth as determined by a variety of factors—the tangible assets of the corporation, its earnings, its prospects, its undivided surplus, etc.

It is not necessary that all the shares be subscribed for or issued at the time the business is incorporated. A corporation may be organized with a capital stock only part of which has been subscribed for, the rest being held in reserve as unissued stock for future subscribers. But a certain proportion of the capital stock (usually small) must be subscribed for and paid in before the corporation can begin business.

Full-Paid Stock

Stock in the corporation may be issued to subscribers on any basis that the directors, with the assent of the stockholders, deem best. That is, it may be issued for its full face value in money, property, or services; or for only a portion of its face value, on partial payments, or as a gift. If, however, the full face value is not paid in money, property, or services, it is not full-paid stock, and consequently carries with it a stockholder's liability to creditors of the corporation for the amount unpaid.

Treasury Stock

At the time a corporation receives its charter a certain percentage of its authorized capital stock generally remains unissued. This unissued stock represents nothing whatever beyond the potential right of issue reserved by the company. Consequently, unissued stock has no intrinsic value. This being so, the unissued stock cannot in any way be regarded as an asset of the corporation.

Treasury stock, however, is stock that has once been issued for value and then reacquired by the corporation, and for the time being held in its treasury subject to disposal by the directors. So long as such stock is held by the corporation, it is inert and can neither be voted nor participate in dividends. It constitutes an asset on the books of the company, the value of it depending upon the intrinsic value of the corporate shares. The shares may be sold by the company below par to raise funds for corporate purposes, distributed among stockholders

as a bonus with preferred stock or bonds, or otherwise disposed of without subjecting the recipient to liability to creditors of the corporation, provided, of course, it was full-paid stock when originally issued.

By-Laws

When a sovereign (the state) creates a corporation, it grants the corporation by implication all powers necessary for carrying into effect the object for which it was created. It is therefore incidental to every corporation to have power to make by-laws and adopt regulations relative to the purpose for which it was created. Such a power is incidental when not specifically granted, and is subject only to the following restrictions:

1. The by-laws must not be repugnant to the charter.
2. They must not be contrary to public policy or opinion.
3. They must be reasonable.
4. They must not impair vested rights.

The three primary sources of corporate regulation are, therefore:

1. The corporate charter
2. The by-laws
3. The board of directors

Once a charter is obtained, the corporation must adopt rules defining the rights of members, duties of officers, times of meetings, and other matters incidental to the proper government of the company.

Function of By-Laws

It is the function of the corporate by-laws to provide for such details of organization, administration, and business routine as are not prescribed by and set forth in the charter. So far as the law is concerned, there is no legal necessity for

adopting by-laws, but the operation or functioning of a corporation without them would be practically impossible.

The power to enact by-laws resides in the stockholders, unless the state statute confers it upon the directors. It would seem to be more properly vested in the stockholders as the constituent body of the corporation, but under some statutes the power has been given to the directors. In fact, when given them, this power to make by-laws constitutes one of the most important and effective rights of stockholders, because where restriction is to be placed upon the powers of directors, recourse is found in by-law provisions.

By-laws usually prescribe the general organization of the corporation. Hence the adoption of a carefully prepared set of by-laws is, as a rule, one of the first important steps taken in the organization of a corporation.

Scope of By-Law Regulation

By-laws should provide fully for all the important details of corporate procedure, such as the issuance and transfer of stock, the meetings of the stockholders and directors, the election of directors and officers, together with the respective duties and responsibilities to be assumed by these officers, and the care and management of the corporate property and finances.

The by-laws usually prescribe the means whereby any of the provisions may be repealed or amended—generally by a majority vote of a quorum of stockholders at any regular meeting or at a special meeting called for the purpose. Direct penalties are sometimes provided for the violation or nonobservance of the by-laws. Such penalties, as a rule, take the form of fines. The more serious violations bring their own penalties in the legal liabilities that follow.

Corporate Control—Stockholders

The shareholders are those persons who have contributed capital to the enterprise and who are interested in the operation

of the company, inasmuch as their shares represent undivided interests in the corporate enterprise. They have no direct ownership in any of the property of the corporation; nor are they creditors of the corporation. They simply own the shares. The corporation holds the legal title to all the properties acquired, but it holds it for the pecuniary benefit of those persons owning the capital stock. They select the persons to manage its affairs; they also have the right to share in surplus earnings, and after dissolution they have the further right to have the assets reduced to money and ratably distributed. Each share represents a distinct interest in the whole of the corporate property.

In the active conduct of the business affairs of the corporation, the stockholders do not directly participate. The actual management and the general control of the corporation is vested in the board of directors with whom the stockholders cannot directly interfere.

Directors

The board of directors (a distinction must be drawn between the directors as individuals and the directors acting as a board) has sole charge of the business of the corporation and the control of its property. It is the managing body of the corporation. The powers of the board do not, however, extend beyond the purposes for which the corporation was formed. For example, they cannot sell the entire corporate assets, or mortgage the corporate property, without the consent of the stockholders. Their authority is still further restricted by the by-law provisions. The authority of the directors may be exercised only as a board in meeting assembled and with a quorum present.

Directors of a corporation are virtually trustees for the body of stockholders, and must exercise the same degree of care and diligence in the conduct of the corporate affairs as prudent business men in the conduct of their own affairs.

In order to obviate the necessity for frequent meetings of the board and to secure prompt and decisive action on questions that arise, the board generally has power to appoint standing committees, such as an executive committee and a finance committee. It is the duty of these committees to act and then report to the board. In event the committee desires to shift the responsibility back to the board, they will report the matter to the board with a recommendation that the desired action be taken.

Officers

Besides these standing committees, the board can act only through the officers and agents which it appoints. The usual executive officers of a corporation are a president, vice-president, treasurer, and secretary, any two of which may be held by the same person if the duties are not incompatible. The officers of the company carry out the instructions of the board, and have no independent powers or authority outside the duties and privileges given them by the by-laws.

Corporate Finances

The treasurer is the fiscal agent of the corporation. He has charge of its funds, securities, and general assets. The disbursement of the corporate funds is usually made under carefully prescribed conditions in the by-laws. As a rule, they provide that payments shall be made by the treasurer in accordance with the instructions of the directors. The treasurer usually countersigns all obligations issued by the corporation in the form of contracts, checks, notes, and, in general, handles its money and negotiable paper.

Legal Liability of Corporation

In the first place, a corporation can legally enter into and carry out only such acts as it is either expressly or impliedly authorized to perform by its charter.

By "implied powers" is meant powers necessary to carry out its express powers, and not powers to engage in some collateral enterprise only remotely connected with the corporate purpose. The word "necessary" is used here not in the sense of being indispensable, but obviously appropriate, needful, suitable, and proper to accomplish the purpose for which the company was incorporated.

Any acts in excess of its charter powers, either express or implied, are *ultra vires* (beyond its power). However, the legal consequences of such *ultra vires* acts vary. In the state courts a party to an *ultra vires* contract which has not been performed (an executory contract) may always set up the want of corporate capacity as a defense to being held liable on the contract. But the law will not interfere with a performed or executed contract, even though there was a lack of corporate capacity to enter into it. In applying the doctrine of *ultra vires* in the federal courts, however, the rule is that the contract of a corporation which is *ultra vires* is absolutely void and of no legal effect. Where there has been a part performance of such a contract, the party who has performed his part cannot sue on the contract, but can recover in quasi-contract on the basis of unjust enrichment. In New York, when there has been a part performance and the parties cannot be restored to their original status, the courts will enforce the entire contract.

Stockholders' Liability

The interest, control, and management of a corporation are vested in: (1) the stockholders, (2) the board of directors, and (3) the officers, but the nature of their respective legal liability is quite different.

In most states a stockholder is liable only for corporate debts only up to the face value of his holdings; so if the face value of his stock has been paid for in full his liability ceases and he is no longer responsible for the corporate indebtedness.

On the other hand, if a corporation becomes insolvent, the holder of stock not fully paid for is directly liable to the corporation, and indirectly to its creditors, up to the face or par value of his stock.

In order to illustrate the legal significance of this doctrine, let us assume, for example, that a corporation is incorporated for $50,000, and has issued all of its stock, but only 50 per cent of the par value has been paid in. Unexpected losses coupled with inefficient management result in an almost complete loss of this $25,000. There is still $25,000 due from the stockholders which may be called in by the directors at any time. Let us assume, however, that they refuse to call it in. The creditors of that corporation, after having reduced their claims to judgment, can file a bill in a court of equity against the stockholders of the company and the court will decree that each of the stockholders holding share certificates which have not been paid for in full shall pay a pro rata share thereof, or a sufficient part to satisfy the claims of the plaintiffs, or judgment creditors.

There are exceptions to this rule in several states. Thus, in Minnesota a stockholder is liable to creditors, in case the corporation becomes insolvent, for a further amount equal to the par value of his stockholdings. This is an important exception to be taken advantage of by credit men in handling claims against insolvent companies incorporated under the laws of Minnesota. In California each stockholder is liable for any portion of his subscription that is unpaid, and also for such proportionate part of the corporate indebtedness incurred during the period in which he was a stockholder, as his stock bears to the total capitalization of the corporation.

A stockholder has not an attachable interest in the property of a corporation. The corporation as such has full title and the sole legal interest in all its property, and the individual members of the corporation are not the owners of the corporate property. A share of stock represents a mere right of membership in a

corporation, which, however, may be attached by serving a writ of attachment on an officer of the corporation at its main office, who will make record thereof on the corporate records.

Directors' Liability

The directors of a corporation occupy a fiduciary relation with respect to the stockholders quite analogous to the relation that exists between a trustee and the beneficiary. In fact, the directors are often said to be "quasi-trustees" of the corporate property for the benefit of the stockholders, and they are therefore held to the exercise of the highest degree of fidelity in all dealings involving the rights of stockholders. Upon the dissolution of a corporation the directors become trustees for the creditors of the corporation.

Under the common law the directors are personally liable for loss or damage resulting from *ultra vires* acts, or for acts exceeding the authority given them by the corporate charter, for any unlawful corporate act committed with their connivance, knowledge, or assent, for issuance of unpaid or partly paid stock as full paid, for the unlawful payment of dividends, and for any other gross mismanagement. They are not, however, responsible for the results of errors of judgment in their management of the ordinary affairs of the corporation.

Further liability has been placed on corporate directors in some states by statutory enactment, making the directors criminally liable under the laws against fraud, larceny, and embezzlement. A dissenting director can always relieve himself from legal responsibilty by taking exception to such action and having his protest incorporated in the minutes.

Officers' Liability

It is commonly thought that the president and other officers of a corporation have very extensive powers, but this is not necessarily so, as they have only such powers as are

vested in them by the board of directors. Consequently, an officer contracting for his corporation within the limits of his authority is merely acting as a corporate agency, and, in the absence of fraud or deceit, does not bind himself and cannot be held personally liable in any way. If, however, he exceeds his authority, he renders himself personally liable, unless the corporation later ratifies his action, in which case he is released from further liability.

A corporation may act *per se* through its own administrative officers, its inherent agencies, or *per alium,* through its especially appointed agents. Corporate officers are the agencies of the corporation. They are not agents of the corporation and their acts are not governed by the law of principal and agent. When the officers act in behalf of the corporation in their official capacity, the act done is one of the corporation *per se* and not *per alium.* On the other hand, when the officers of a corporation create a liability on the part of the corporation by virtue of an authorization to that effect by the board of directors, they act as agents of the corporation, and not as the mere instrumentality through which the corporation itself acts.

Officers are bound to use ordinary care and diligence in the conduct of the corporate business, and are therefore liable for any losses resulting from neglect, mismanagement, or wrongdoing in the discharge of their official duties, though not for any error of judgment.

Corporation Reports

The statutes generally provide that a stock corporation shall make an annual report of its affairs and file the same in some public office where any person may inspect it. The purpose of this is to enable persons who may wish to do business with the corporation to ascertain its financial condition. The report usually contains a statement as to the amount of capi-

tal stock outstanding and amount of the assets and liabilities. Some state statutes make the directors personally liable for debts in case they fail to file such a report, and also for debts contracted upon the faith of the report filed in case it is false in any material particular.

PART II

LEGAL NATURE OF SALES

CHAPTER IV

SALES AND SALES CONTRACTS

Essential Knowledge

It is also essential that a credit man should have a clear, correct conception as to the precise nature of the legal obligations he is trading in and the legal rights and remedies that arise in the sale of merchandise. This chapter is therefore devoted to a brief but, in so far as mercantile credit is concerned, a sufficiently complete discussion of the legal aspects of commercial sales and contracts to sell.

In the first place, there is a common basis for all the legal rights and remedies of a mercantile creditor, whether wholesale or retail, and that is the fact that they all arise out of and result from the sale of goods, wares, and merchandise. And in so far as the legal aspects of his work are concerned, a credit man has to deal mainly with contracts involving the sale of goods, and the enforcement of obligations resulting from and growing out of the actual sale of goods. Consequently, he needs to know what constitutes a binding contract of sale, what obligations and rights result therefrom, and what steps are necessary to its legal performance. It will, therefore, be the object of this chapter to state and explain the application of some of the most important legal principles that have been established in this connection.

Legal Distinction between Sales and Contracts to Sell

All legal contracts begin with an agreement, by which is meant a meeting of the minds of the contracting parties in a common assent to the same set of facts. This agreement is of a twofold nature in that it may be such as actually to trans-

fer a present right and title to goods, or as only to create an obligation to transfer the right and title to goods at some future time. In other words, the agreement may partake of the nature of a sale or only a contract to sell. There is an important distinction to be made between the two, and the legal rights and remedies arising therefrom are quite different. The principal distinction is that a sale (Form 1) is a completed transaction, wherein the ownership of the goods has passed from the seller to the buyer, even though the seller may still

Sales Agreement

This agreement certifies that I, Herman A. Riddell, of Augusta, Georgia, have this day bargained and sold to James C. Swift, of Elberton, Georgia, the Four Hundred (400) bushels of wheat now stored in my name in the Bussey Warehouse # 86 Greene Street, Augusta, Georgia, delivery to be taken as needed within sixty (60) days from date.

And in consideration for which said James C. Swift hereby agrees to pay said Herman A. Riddell the sum of five hundred dollars ($500) within thirty days from date.

Signed:
Herman A. Riddell
James C. Swift

November 10, 19—

Form 1. A Sale

retain possession of the goods and the price may not have been paid at the time the sale was consummated; whereas a contract to sell (Form 2) means that the ownership of the goods is to be transferred at some future time.

Contract to Sell

This agreement made and entered into this tenth day of November, 19—, between Alex G. Drury, of Cincinnati, Ohio; and William Carpenter, of the same place.

Witnesseth, that the said Alex G. Drury hereby agrees to sell and deliver to the said William Carpenter, five hundred (500) bushels of wheat, of good marketable quality, on or before the twenty-fifth day of November, at his warehouse located at # 86 West Fourth Street, Cincinnati, Ohio.

And, that the said William Carpenter in consideration thereof hereby agrees to pay the sum of sixty cents per bushel for the said wheat upon the completion of the delivery thereof.

Signed:
Alex G. Drury
William Carpenter

November 10, 19—

Form 2. A Contract to Sell

However, a letter containing an offer which is accepted by another letter is the simplest and most common form of contract to sell. The offer may be made as follows:

> DEAR SIR:
>
> Our company has on hand some 30 or 40 tons of nut and bolt scraps which we shall be pleased to sell at $1.30 per hundredweight, terms 30 days, and deliver in Winton Place within five days after order. We will sell in lots of not less than 10 tons.
>
> Kindly advise at your earliest convenience if you desire any or all of this material.
>
> Yours very truly,

The acceptance of this offer may be made thus:

> GENTLEMEN:
>
> In reply to your letter of ...., I shall be pleased to take 15 tons of the nut and bolt scraps you describe, at the price and subject to the terms named, provided same is delivered on or before the .... of this month.
>
> Yours very truly,

The following distinction between a sale and a contract to sell is made in the Uniform Sales Act:

> A sale of goods is an agreement whereby the seller transfers the property in the goods to the buyer for a consideration called the price.
>
> A contract to sell goods is a contract whereby the seller agrees to transfer the property in the goods to the buyer for a consideration called the price.

The importance of this distinction becomes readily apparent when it is pointed out that where the goods have been actually sold and the buyer makes default, the seller may sue for the contract price; but where an agreement to sell is broken, the seller's remedy is an action for unliquidated damages resulting from the breach of contract.

Requisites of a Sales Contract

In order that a contract shall be enforcible, that is, one for the non-performance of which the law will give damages, it

must comply with the following requisites. There must have been:

1. Mutual assent,
2. By competent parties,
3. Upon adequate consideration,
4. For a legal object, and
5. It must have been made without mistake, fraud, or undue influence.

1. Mutual Assent

It is essential that the parties to a contract should agree on the terms, or, in legal phraseology, that "there should be a meeting of minds." This agreement results usually from an offer made by one party and accepted by the other. The offer may be oral or written, except as qualified by compliance with the Statute of Frauds. (See page 54.) The simplest form of contract consists of an offer to sell goods at a specified price and an acceptance of the goods at that price. If the offer is made by letter and the acceptance is made by letter, the two letters taken together constitute a complete contract of sale, provided the acceptance is in the same terms as those in which the offer was made. To accept an offer in any terms other than those in which the offer was made amounts to a refusal to accept the offer as tendered. When nothing is said in the offer as to the manner of payment the law implies cash. When nothing is said about the time for delivery the law implies that the buyer is to be entitled to delivery of the goods upon payment of the price.

It is but rarely that the parties to a contract express their assent simultaneously. Nearly always such an agreement is arrived at by a process of offer and acceptance of terms. If the offer is made by mail or telegraph, the post office or telegraph company becomes the agent of the seller to receive the acceptance of the buyer, and the contract becomes binding the moment a correctly addressed letter of acceptance is deposited in

the mail box, even though it should fail to reach its proper destination; or the moment a prepaid telegram, properly addressed, is given to the telegraph company for transmission to the seller. Prior to such acceptance by the buyer the seller has a right to revoke or withdraw his offer, provided he actually notifies the other party of his withdrawal before the other party has accepted his offer.

If an offer is made by mail or telegraph the acceptance must be communicated through the same medium in which the offer was received. If, on the contrary, a different agency is used, there is no contract until the acceptance has actually been received by the seller. It therefore follows that if the seller makes an offer by wire, which the other party accepts by mail, the seller may revoke his offer at any time prior to receipt of the letter of acceptance; whereas if the original offer had been made by mail, the mail acceptance would have constituted a binding contract upon mailing.

If an offer is made to one person, no other person can accept it. Likewise, if made for only a limited time, it must be accepted within that time. Where no time limit is specified the offer must be accepted within a reasonable time. What constitutes a reasonable time depends upon the nature of the circumstances attending it, and of the commodity or subject matter of the offer.

2. Competency of Parties

With certain exceptions all persons are able to enter into binding contract relations. Contracts made during infancy are voidable at the infant's option and subject to disaffirmance upon his becoming of age. (In other words, an infant—meaning a person under 21 years of age—continues to be troublesome legally even after he has ceased to be troublesome as a child.) However, an infant's contracts are binding upon the adult with whom they are made. Likewise, if one contracts with an insane person, knowing him to be insane, the contract

is voidable by the lunatic. There is one exception to this general rule qualifying the contractual capacity of infants and insane persons—a merchant may supply either one with absolute necessities for life and health, and will be legally entitled to payment for them.

At common law married women were incapable of making binding contracts, but this disability has since been removed by statutory provisions in the different states, and as a rule married women today possess the same contractual capacity as unmarried women. But it is always advisable to consult the law of the state in which the contract is to be entered into before entering into a contract with a married woman, as a few states still restrict the measure of her legal responsibility.

3. Consideration

A mere promise to do or to give something is not in and of itself enforcible by law. Some consideration must be given for the promise by the other party to make it legally binding. This generally consists in some legal detriment suffered by the promisee, the party receiving the promise, in relying upon the other's promise, and there is usually some corresponding benefit to the promissor, the party giving the promise. In other words, mutual promises constitute adequate consideration on the part of both parties, by which is meant that if one party makes a promise in return for another's promise, the law will compel him to carry out his promise when the first party has fulfilled his.

The law allows persons to affix their own value to their respective promises, and the consideration need not equal in value the promise in return for which it is given. It may be very small in comparison with the value of what is agreed to by the other party. In fact it is a common practice in drawing up contracts and bills of sale merely to specify the sum of $1 where the parties do not wish to disclose the full amount of the consideration.

It may be stated that, as a rule, if the promisee does, or forbears from doing, anything he is not legally bound, or forbidden to do, this in itself is sufficient consideration. If, however, the consideration agreed to by one of the parties is something impossible to perform, the contract is void and unenforcible, for he could not be required to perform it and consequently has given nothing. Likewise, the doing of something one is already obliged to do is not a valid consideration, because no additional legal liability is thereby incurred. For example, a promise to settle a past-due account would not be a good consideration for some new sales agreement.

4. Legality of Object

A contract to do anything contrary to law would be unenforcible, and there are a very considerable number of instances (varying in the different states) in which contracts are held to be illegal because contrary to public policy. Only the few of especial interest to the credit men will be enumerated.

Gambling Contracts, wherein one party sells goods to another for future delivery at a specified price, but in fact neither party intends an actual delivery of the goods to be made, but rather a settlement in money on the delivery day, are illegal, inasmuch as it is the equivalent of betting as to what the market price for that particular commodity will be on a certain day. It corresponds to what is known among security-brokers as "bucket shopping."

Contracts for the Sale of Adulterated Goods are forbidden and made illegal by the Pure Food Law, which is supplemented by special statutory provisions enacted in the different states. Being made illegal, such contracts are, of course, unenforcible.

Contracts in Restraint of Trade may be legal or illegal depending upon whether the restraint is reasonable or unreasonable. Under the Clayton Law whether a discrimination in price between different purchasers of commodities or an exclu-

sive purchase and sale arrangement is illegal, depends upon whether its "effect" may be to substantially lessen competition or to create a monopoly. In other words, the Clayton Law renders it exceedingly difficult for a person engaged in mercantile trading to tell in advance whether, if he shall discriminate in price between purchasers or make an exclusive purchase and sale arrangement, he will thereby violate the law, because he cannot foresee what ultimate effect upon competitive trade and monopoly his conduct may have.

Agreements on the part of producers and manufacturers to fix the resale prices of retailers, have been held to be in restraint of trade and void, even in the sale of goods manufactured under a secret process.

5. Mistake, Fraud, and Undue Influence

Legal contracts result from the meeting of minds of the contracting parties, and if either or both parties consent by mistake, or are misled by some misrepresentation or fraud, or are compelled to consent by duress or undue influence, such contracts may later be avoided by the party misled. On the other hand, there is a legal maxim to the effect that "ignorance of the law excuses no one," meaning that the mere fact that an illegal contract has been entered into in good faith does not suffice to excuse a man when he later learns of its illegality.

(a) Mistake. There are two kinds of mistakes possible in making a contract:

(1) A mistake as to the subject of the contract, namely:
   Its existence.
   Its identity.
   Its quality.

(2) A mistake as to features of the contract other than the subject matter:
   The party with whom one is dealing.
   The terms of the agreement.

A mutual mistake as to the existence of the subject matter of the contract prevents any contract from being entered into.

> EXAMPLE: A sells B a cow. Unknown to either party the cow had died prior to the contract being entered in to. No contract has been entered into because there was no cow in existence to constitute the subject matter the parties had in mind.

A mistake as to the identity of the subject matter enables either party to avoid the contract.

> EXAMPLE: A had two Packard automobiles, one a touring car and the other a roadster. B purchased the touring car and offered to sell A's Packard to C for $2,000. C, believing A to own only the roadster and thinking it was the one to which B referred, accepted the offer. There is no binding contract, because the minds of B and C did not meet on the same subject matter.

A mistake as to the quality of the goods does not ordinarily suffice to avoid the contract.

> EXAMPLE: A purchased a quantity of second-grade wheat from B at 30 cents a bushel and resold this same wheat to C at 31 cents a bushel. Later A learned that the wheat was first-grade quality, worth 40 cents a bushel, and wished to avoid his contract with C. The contract is binding.

A mistake as to the identity of the party with whom one is dealing will avoid a contract. A party cannot be forced into an agreement with someone with whom he did not intend to contract.

> EXAMPLE: A has been doing business for years at a certain address with B. Unbeknown to A, B has sold out his business to C, who continues to carry on the business under the same name. C sends an offer for goods to A which is accepted, and shipment is made, but before the goods are delivered A learns of the change in proprietorship and stops the shipment in transit. There was no binding contract. A has a right to select whom he will deal with and is not obliged to recognize strangers under such a mistaken identity.

If an error is made in the terms of the agreement so that it misrepresents the actual agreement intended to be entered into by the parties, such an error does not necessarily avoid the contract, and it may be enforced according to the terms actually intended.

> EXAMPLE: A owns a 6-cylinder Buick automobile which he contemplates trading in to B, a used-car dealer. B in turn tells C of the contemplated deal "for A's 4-cylinder Buick." C has ridden in the car with A and agrees to purchase it from B for $900. Later both B and C learn that it is a 6-cylinder car. The contract is binding as there was a meeting of minds on the particular Buick owned by A, whether it had 4 or 6 cylinders.

(b) FRAUD. Fraud consists in a false representation of fact, knowingly and intentionally made with the intention that it should be acted upon by another, and actually acted upon to the other party's damage. If there is any such fraud in inducing a party to enter into a contract, he may refuse to perform his part of it. If the contract is carried out before the fraud is discovered, the seller may later recover his goods or their value. He may also let the contract stand and sue for damages covering any loss he may have suffered.

Misrepresentation of fact may take the form of collateral promises and become express warranties, for the breach of which recovery may be had at law (see page 77).

(c) UNDUE INFLUENCE. Contracts must be entered into freely and voluntarily. A person must consent to a contract of his own free will. Consequently, where there has been an unconscientious use of power by one over the will of another, whereby the latter is induced to make contracts he otherwise would not enter into, such contracts are void and unenforcible. Instances of this nature, however, are comparatively rare and seldom arise in the work of a credit man.

Statute of Frauds

Practically every state has enacted some special statute requiring certain formalities to be complied with in the incur-

rence of certain obligations as a necessary precaution against the perpetration of fraud, or the possibility of mistake as to the terms of the transaction. This statute is generally termed the "Statute of Frauds."

Section 17 of the English Statute of Frauds, which is the one adopted by most states, provides that contracts for the sale of goods, wares, and merchandise of the value of $50 or more, must be evidenced either: (1) by the acceptance and receipt of the goods, or a part of them, or (2) by the payment of some part of the purchase price, or (3) by some note or memorandum in writing signed by the party to be charged or his authorized agent.[1]

In other words, under this section of the statute you cannot charge a buyer on a sale amounting to $50 or over, unless there has been a part delivery, part payment, or a memorandum signed by the buyer or his authorized agent.

Memorandum of Sale

In the latter case the memorandum (Form 3) may be in any form, but it must contain three elements:

1. Names of the contracting parties.
2. Description of the subject matter of the transaction.
3. Terms of the agreement.

1. The Names of the Contracting Parties. The memorandum should identify the parties and show the relationship of buyer and seller. However, it need not be signed or subscribed by both parties; it is enough that the one who is sought to be charged has signed it.

Example: A sells B 1,000 bushels of wheat at $1 a bushel. B signs the memorandum but A does not. A may maintain an

[1] This section of the English Statute of Frauds, with slight changes, has been enacted in most of our states, the exceptions being Alabama, Arizona, Delaware, Illinois, Kansas, Kentucky, Louisiana, New Mexico, North Carolina, Ohio, Pennsylvania, Rhode Island, Tennessee, Texas, Virginia, and West Virginia. The limitation as to the amount varies, however, from $30 in Missouri, Arkansas, and Maine, to $2,500 in Ohio; whereas in both Florida and Iowa all transactions for the sale of goods of whatever value are within the statute. Arizona, Illinois, Ohio, Pennsylvania, Rhode Island, and Tennessee have since enacted the Uniform Sales Act.

action against B in case he refuses to accept the wheat, but B could not maintain an action against A in case he refused to deliver it.

It is therefore advisable that both parties should sign because of the uncertainty as to which party may seek to avoid the performance. An authorized agent may sign for either party.

MEMORANDUM OF SALE
THE KEMPER-BETTS COMMISSION COMPANY
263 Parker Street, Cincinnati, Ohio

November 10, 19—

We have this day sold to Charles S. Lee, 2363 Wold Ave., Cincinnati, Ohio, the following goods:

25 tierces of Crisco at $37.50 per tierce
delivery to be made as called for within 30 days
terms, 30-1-10.

THE KEMPER-BETTS COMMISSION COMPANY
GILBERT L. KEMPER, *Treasurer*
CHARLES S. LEE

Form 3. Memorandum of Sale

2. DESCRIPTION OF THE SUBJECT MATTER. The goods to which the sale or contract to sell relates must be described in the memorandum to such an extent as to identify clearly and with sufficient certainty the subject matter of the agreement. This has been construed to mean that the description may be too brief, or it may be worded in such technical terms that the meaning is not apparent to an uninstructed person, but this does not necessarily signify a non-compliance with the statute when the meaning can be shown by parol evidence. Whether a memorandum written entirely in cipher and wholly untranslatable without parol evidence is a good memorandum within the meaning of the statute, Professor Williston, of the Harvard Law School, says, has never been decided.

3. THE TERMS OF THE AGREEMENT. The writing should contain all the terms of the contract clearly specifying the price and terms of payment (if these have been decided upon by the parties), as well as all other material facts and conditions pertaining thereto. In other words, the weight of authority

is to the effect that the memorandum must contain substantially the whole agreement and all the material terms and conditions, so that one reading it can understand from it what constitutes the agreement.

Purchase of Several Articles

Whether or not the purchase of a single article at a fixed price is within the Statute of Frauds is readily determinable. But suppose the subject matter of the purchase consists of several articles the price or value of each being under the statutory limit, yet the total amount of all taken together is in excess of this limit. No definite ruling has been established to cover this point, and, while the question has frequently arisen, the decisions have turned on the particular circumstances of the case in issue. If any general rule or principle can be laid down in this connection, it is that the test in such cases, as to whether a given transaction comes within the statute, is whether the contracting parties intended to enter into separate and distinct contracts with regard to each single article, or to make one entire contract for all of the articles. In the former case it would not, and in the latter case it would, come within the statute.

Statutory Exclusions

In construing this provision in the Statute of Frauds a distinction is made between a contract of sale and a contract for work and labor, the significance of the distinction being that in the case of the former it must comply with the statute, whereas the latter has been held not to come within the statute.

EXAMPLE: A orders B, a shoe manufacturer, to make up for him 1,000 pairs of shoes of certain description, for which A agrees to pay $4,000 when the shoes are made up. A later refuses to accept them, and pleads the Statute of Frauds. The question then arises: Was this a contract of sale? If so, B cannot recover against A because there has been no receipt of goods, no part payment, and no memorandum in writing. If, on the

> other hand, it is a contract for work and labor, B may recover against A because such a contract is not within the Statute of Frauds and is therefore good even though it was not reduced to writing.

In those states where the Uniform Sales Act has been enacted, the subject is fully covered in section 4, which provides:

> (1) A contract to sell or a sale of any goods, or choses in action of the value of five hundred dollars ($500.00) or upwards, shall not be enforceable by action unless the buyer shall accept part of the goods or choses in action so contracted to be sold, and actually receive the same, or give something in earnest to bind the contract, or in part payment, or unless some note or memorandum in writing of the contract or sale be signed by the party to be charged or his agent in that behalf.
>
> (2) The provisions of this section apply to every such contract or sale, notwithstanding that the goods may be intended to be delivered at some future time or may not at the time of such contract or sale be actually made, procured or provided, or fit, or ready for delivery, or some act may be requisite for the making or completing thereof, or rendering the same fit for delivery; but if the goods are to be manufactured by the seller especially for the buyer, and are not suitable for sale to others in the ordinary course of the seller's business, the provisions of this section shall not apply.
>
> (3) There is an acceptance of goods within the meaning of this section of the Uniform Sales Act when the buyer, either before or after delivery of the goods, expresses by words or conduct his assent to becoming the owner of those specific goods.

Acceptance and Receipt of Part of the Goods

Acceptance may be said to involve a mental state or condition rather than an act, although an act may be relied upon as evidence to prove the mental state. To constitute such an acceptance, says Irving Browne in his work on the Statute of Frauds, "there must be such conduct on the part of the buyer in respect to the goods as affords evidence that he has identified and recognized them as the goods which were to be his

by virtue of the alleged contract." It has no necessary relation to the actual receipt of the goods, and "if the contract be for specified goods, the acceptance takes place at the time of the bargain, and the same evidence which proves the bargain will also prove an accceptance."

The term "receipt" relates to the transfer of possession of the goods as distinguished from the transfer of title to the goods. According to Browne:

> The actual receipt of the goods does not necessarily involve a manual taking of possession of them by the buyer. In many cases this would be impracticable, and no other receipt is required than such as is consistent with the nature, locality, and condition of the goods. Though this be merely symbolical, the statute will be satisfied when the case admits of none other. It is, therefore, a general rule in regard to the actual receipt of inaccessible, ponderous, or bulky articles that it may be accomplished by the performance of any act which shows that the seller has parted with the right to control the property, and that the purchaser has acquired that right.

Actual acceptance and receipt of part of the goods, however small, will suffice to satisfy the statute if the part or sample is accepted and received as part of the lot of goods sold or contracted to be sold. On the other hand, if at the time the buyer accepts and receives part of the goods he declines to accept any more, the statute is not satisfied, because the buyer does not accept and receive same as only a part of the whole.

Part Payment

A payment not made at the time the bargain is entered into cannot under any circumstances satisfy the requirements of the statute. But when a valid contract for the sale of goods is entered into and the buyer later pays a part of the purchase price expressly to bind the contract, or when payment is made and the parties reaffirm or restate the terms of the contract, the statute is undoubtedly satisfied, because such payment is then made "at the time of the contract" and not afterward.

Effect of Non-Compliance

The legal effect of non-compliance with this statute is not uniform in all jurisdictions. In the first place, if it is not set up as a defense to the action, oral evidence of the agreement is admitted in most jurisdictions. It has also been held in some jurisdictions that where a memorandum of the transaction was obtained after the making of the agreement but before the commencement of the action, the statute is satisfied. It therefore seems preferable, as one writer has said, to hold that the statute has to do with certain prerequisites to the bringing of an action rather than with certain methods of proof. In other words, the statute operates as a rule of procedure, and in this respect is analogous to a Statute of Limitations which prohibits the plaintiff from enforcing a right of action unless he begins his suit within a certain period.[2]

If the original contract is and had to be in writing under the Statute of Frauds, all modifications of it must likewise be in writing.

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[2] See Schaub and Isaacs, The Law in Business Problems, p. 193.

CHAPTER V

THE PASSING OF TITLE

Importance of the Time of the Passing of Title

Perhaps the most important phase of the law of sales has to do with the passing of title, because on it depends the legal rights created by the parties at the time the transaction is entered into, and the determination as to whether or not the risk of loss has been shifted from the seller to the buyer. Furthermore, if title has passed the goods are subject to attachment by creditors of the buyer, and the seller may maintain an action for the purchase price of the goods; whereas, as has previously been pointed out (see page 47), if title has not passed, the seller's action would be for damages for breach of contract.

Although it is important to ascertain the time when title passes from the seller to the buyer, the precise nature of the relation created between the parties is oftentimes difficult to determine, because in the absence of fully expressed and specified terms of sale it is the implied intention of the parties that governs.

> EXAMPLE: A sells B $5,000 worth of lumber, and it is agreed that the following day A is to have it assorted into grades, ready for shipment to different points according to grade. That night the lumber is destroyed by fire, and the question arises as to which of the parties shall bear the loss. Nothing was said or agreed upon as to just when title to the property should shift from A to B, although the importance of this aspect of the transaction is, under the circumstances, obvious.

The importance of such information to the credit man is readily apparent, because once a sale is made it eventually

devolves upon the credit department to handle the collection of the purchase price, and it is first necessary to ascertain one's legal rights in order to be in a position to handle such matters intelligently. Furthermore, it should not be necessary for an experienced credit man to pay an attorney for information which he can readily obtain for himself, and with which he should be familiar.

Rules Governing the Intent of Parties

In a contract to sell, the time at which title to the goods passes depends upon the intention of the contracting parties, provided such intention is manifest from the terms of the contract. In other words, the parties can agree to anything they desire with regard to *when* the title shall pass; but if they agree upon the price, terms of payment, place of payment, time of delivery, place of delivery, and everything except as to when title to the goods shall pass from the seller to the buyer, the law has laid down certain rules or principles determining the implied intention of the parties when no clear intention is manifest or expressed in the terms of the agreement.

Rule 1. Where there is an unconditional contract for the sale of specific goods in a deliverable condition, title to the goods passes to the buyer when the contract is made, even though payment or delivery or both is to be made at some future time.

> Example: A sells B a lot of lumber for $1,400 and it is agreed that the lumber shall be delivered the following week and paid for within 40 days. That night the lumber is destroyed by fire. Title was in B and he therefore must bear the loss—not the seller.

Rule 2. Where there is a contract for the sale of specific goods, but the seller is obligated to do something to the goods to put them into a deliverable condition, title to the goods does not pass to the buyer until this has been done.

EXAMPLE: A sells B a quantity of lumber and agrees to have it assorted into various grades for shipment to different manufacturing points of B. That night the lumber is struck by lightning and destroyed. B is not bound to pay the purchase price because title does not pass from A to B until the lumber has been assorted by A.

This rule, says Professor Williston, of the Harvard Law School, seems to be founded in reason. In general, it is for the benefit of the seller that the property or title should pass, because the risk of loss is thereby transferred to the purchaser, and as the seller may still retain possession of the goods so as to retain a security for payment of the price, the transference of the property to the seller is pure gain. It is therefore reasonable that where by the agreement the seller is to do something before he can call upon the purchaser to accept the goods as corresponding to the agreement, the intention of the parties should be taken to be that the seller was to do this before he obtained the benefit of the transfer of the property.

Rule 3. Where the subject matter of the sale consists of fungible goods (goods which upon being mixed together completely lose their identity and are no longer susceptible to separation into their component parts, such as oil, wine, wheat, etc.), title to a fractional part of the whole passes immediately, and the purchaser becomes a co-owner, or tenant in common.

EXAMPLE: A sells B 50 barrels of oil, constituting part of the contents of a tank containing 150 barrels—delivery to be taken by B in B's tank car at any time within 10 days. That night A's entire place of business is destroyed by fire. Title to ⅓ of the contents of the tank passed to B at the time of the sale, and the loss is therefore B's, not A's.

Some states, however, hold that where the measuring or weighing at the time of delivery is to be done by the seller in order to ascertain the price the buyer is to pay, title does not pass until this has been done.

Rule 4. This rule is concerned with C. O. D. and approval sales as follows:

(a) Where goods are sold C. O. D. for local delivery, title does not pass until the goods have actually been delivered, the carrier in such instances acting as the agent of the seller.

(b) Where goods are sold C. O. D. for delivery at a distance, title passes on delivery to the carrier, the carrier in such instances acting as agent of the buyer. In other words, a delivery to a carrier pursuant to the expressed or implied direction of the purchaser, is a good delivery to him.

(c) Where goods are sold on approval, title does not pass until the goods are actually delivered and the buyer either indicates his approval or retains the goods an unreasonable length of time.

Rule 5. If the agreement provides for delivery to the buyer at a particular place, title does not pass until the goods have reached the buyer or the place agreed upon.

The fact that the seller is to pay the freight does not prevent title from passing to the buyer on delivery to the carrier. If the goods are sold "freight prepaid," it does not necessarily obligate the seller to make delivery, and his responsibility ceases when he has delivered the goods to the carrier and obtained a receipted bill of lading.

Right of Inspection in C. O. D. Sales

Under ordinary circumstances, when a seller sells and ships goods of specified description, the buyer clearly has the right of inspection before acceptance. And if the goods are in accordance with the terms of the order, title passes at the moment of shipment and the purchaser is bound to pay the price. On the other hand, if they do not fulfil the required conditions, the buyer need not accept them and there is no sale.

But when goods are shipped C. O. D., do the same principles apply? According to the better opinion the condition of collection on delivery does not prevent the passing of title

upon delivery to the carrier. As to its effect upon the right of inspection, however, the authorities are not in accord.

It has been held that the carrier incurs no legal liability to the consignee for refusal to allow inspection. An express company, however, which allowed inspection was held not liable in an action brought by the seller. In this case the carrier had delivered the goods to the purchaser upon deposit of the purchase price, and had agreed to return the deposit if the goods proved unsatisfactory.

There is a general rule, however, among express companies not to allow inspection of goods sent C. O. D., and in cases where this method of shipment is contemplated the parties might well be taken to have agreed that this rule should form an implied element of the contract. After payment has been made and the goods obtained, if they should prove not to be in accordance with the order, the buyer would have the usual remedies for breach of the implied warranty that the goods conformed to the description. In some jurisdictions he could sue only for damages; in others, he would be allowed the option of rescission or damages. On principle he clearly should have this option, since he had no opportunity to inspect the shipment.

Assuming the purchaser had not authorized the shipment of the goods C. O. D., he could not be taken to have contracted with reference to the rule of the carrier, and consequently his right of inspection would remain and such a consignment would therefore not constitute a valid tender.[1]

Delivery

In a sale, delivery, which may be either actual or constructive, is made at the time the sale is consummated. The delivery may consist in merely setting aside the goods, but the title passes just the same as though actual delivery of them had been made to the purchaser. In instances where con-

[1] See XVIII Har. Law Rev. 386.

structive delivery only has been made and the goods are later destroyed, title having passed, the loss is the purchaser's.

On the other hand, it is impossible to transfer the ownership of goods that have not been made specific. For example, a contract to sell 10 barrels of flour possessing certain specific qualifications does not transfer title to the flour until some specified 10 barrels have been designated as the subject matter of the contract. Usually the selection is made by the buyer, but in some cases the buyer directly or indirectly authorizes the seller to make the selection for him.

Assent of Buyer to Passing of Title on Delivery to Carrier

Delivery of goods to the carrier under a contract to sell ordinarily passes title to the buyer, but if the shipment is not strictly in accordance with the contract, the buyer must assent. In the absence of any contract, title could not pass until the time the buyer accepted the offer and assented to receive the title.

Sales without Delivery

There is always an element of risk involved in leaving goods in the seller's possession, for this reason—if the seller is dishonest enough to resell the goods, there would be no right of recovery of the goods from any third party to whom they have been resold or pledged.

This is certainly true of the states which have adopted the Uniform Sales Act, which makes a seller who has the goods left in his possession the agent of the buyer to sell, pledge, or otherwise dispose of them. This is also true of other states in which the Uniform Sales Act has not been adopted (California, Colorado, Kentucky, Maine, Montana, Oklahoma, South Dakota, Vermont, and Washington).

Although seemingly unjust on the surface, the doctrine is made necessary by the opportunity such a situation affords to mislead innocent third parties who, having no notice of the

previous sale, would therefore be justified in proceeding on the assumption that the property rightfully belonged to the seller.

In some states a somewhat different doctrine prevails, and the court will presume that leaving the property with the seller amounts to a fraud, but the first buyer may rebut this presumption, prove the sale bona fide, and recover the property. If, on the other hand, it can be shown in any case that the sale was not bona fide, but merely a sham, a creditor of the seller may treat the goods left with the seller as belonging to the latter and levy on them in settlement of his claim.

A third party purchasing such goods with knowledge of the previous sale could not obtain a good title. Therefore, where for any reason possession of the goods is to be left with the seller for any great length of time, a formal bill of sale should be filed in the proper office of record.

Conditional Sales

It is entirely possible in the sale of goods for the seller to give the purchaser possession of the property constituting the subject matter of the sale but still retain the ownership of the property until the purchase price is paid. Such agreements are known as "conditional sales" (Form 4).[2]

The technical distinction between a conditional and an absolute sale is that the sale is absolute when the transfer of title is complete, whereas in a conditional sale the title is not transferred but is to be transferred at some future time, upon the performance of a condition, namely, payment of the purchase price.

In other words, in an ordinary conditional sale the payment of the purchase price is by the express terms of the agreement a condition precedent to the transfer of title to the goods. Sales made on the instalment plan and providing that

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[2] Because of the existing variations in the state laws on the subject of conditional sales different forms must be used to comply with the different requirements.

CONDITIONAL SALES AGREEMENT

This agreement certifies that Myrtle F. Bowles, the undersigned, now living at 2339 Kemper Lane, Cincinnati, Ohio, has received from the Steinkamp Player Piano Company, a corporation under the laws of Ohio, one Model C player piano, returnable on demand, in good order and repair, and valued at one thousand dollars ($1,000). This the undersigned agrees to use with care and keep in good order and condition, and she agrees to pay for the use of it as follows:

On delivery of said property, two hundred dollars ($200), which shall be accepted as payment for rent until January 1, 19—, and thereafter she shall pay at the rate of fifty dollars ($50) per month in advance on the first day of each and every month, without notice or demand, at the office of the said Steinkamp Player Piano Company, No. 642 West Twelfth Street, Cincinnati, Ohio. If default be made in any of the payments so provided, or in case the undersigned shall sell, offer to sell, remove, or attempt to remove said property from under her custody or control, without the consent in writing of the said Steinkamp Player Piano Company, then this lease shall cease and terminate, and the said Steinkamp Player Piano Company, or its agent, is hereby authorized to take actual possession of said property wherever the same may be.

It is further agreed that the undersigned may at any time within said rental period purchase the said player piano by paying the named valuation therefor, and in that case the rent therefore paid shall be deducted from the purchase price. If any instalment of rent is not paid when due, or if said property is not returned upon demand, the undersigned agrees to pay an attorney's fee of twenty-five dollars ($25) in case her lease is placed in the hands of an attorney for collection of said rent, or to recover possession of the said player piano.

Signed:
MYRTLE F. BOWLES

Cincinnati, Ohio
November 9, 19—.
Witnessed:
HENRY L. WOODWARD

Form 4. Conditional Sales Agreement

title shall pass to the purchaser upon payment of the last instalment, afford a very common but nevertheless typical illustration.

Affidavits to Conditional Sales Contracts

The opportunity afforded for the perpetration of fraud under such circumstances is obvious, and for this reason such sales have been made the subject of special legislation in most states, generally providing that for such sales agreements to be enforcible the seller must file certified copies of them in the proper office of public record. This serves as public notice, just as in the case of a realty mortgage. The importance of

this requisite becomes readily apparent when it is pointed out that in event the seller has not complied with it and the buyer has dishonestly disposed of the goods to some innocent third party, the seller is unable to recover the property.

Destruction of Property Pending Payment

There is such a divergency of opinion in the court decisions on this point that no general rule or principle can be laid down. In some states the seller loses, and in others the buyer. When such destruction takes place the buyer usually discontinues his payments and the question arises as to whether or not he may be held liable for the unpaid balance.

> Example: A conditional sale was made of a soda fountain which was installed in the buyer's place of business and was to be paid for in instalments. Before the final payment was made, the store was destroyed by fire. It was held that the risk of loss was in the buyer, although title was in the seller.

Such a contingency as the loss or destruction of property constituting the subject matter of conditional sales is oftentimes anticipated and guarded against by means of property insurance, the cost of which is, of course, included in the sale price of the goods.

> Example: A conditional sale was made of a player piano, on which a part payment was made and a note given for the unpaid balance. On default at maturity of the note the seller replevined the piano without tendering back the amount of the part payment. It was held that the seller had title to the goods before default and upon default obtained the right to possession of the property also, without tendering back the amount paid, on the ground that it would be unjust to compel him to take back used property and also refund the amount paid on it.

In a few states such forfeiture is done away with by legislation. Section 18 of the Uniform Conditional Sales Act provides for the redemption of the goods by the buyer within a limited period after the seller retakes possession.

State Laws on Conditional Sales

Whereas the state laws on the subject in most states are similar, they are by no means uniform. For instance, some states require an affidavit by the seller setting forth the terms of sale (Michigan, New Hampshire, Nebraska, Ohio, Pennsylvania, and Wyoming). Others only require that the signature of the seller to the contract be witnessed and attested by some responsible third party. Florida goes still further and requires also a personal acknowledgment on the part of the seller.

In the following states it is only necessary to record a copy of the contract signed by the purchaser:

Alabama	New York
Kansas	Oklahoma
Maine	Texas
Maryland	Vermont
Minnesota	West Virginia
Montana	

There are also states in which conditional sales are good against third parties without any such formality:

Arkansas	Nevada
California	Rhode Island
Idaho	Tennessee
Indiana	Utah

Void and Voidable Title

A legal distinction is made between what is termed a "void" and a "voidable" title which becomes of considerable import to a credit man in connection with the recovery of stolen property, and goods with which the seller has parted through fraud.

A thief may have possession as the result of his theft, but he never acquires title to stolen property. He cannot, therefore, pass a good title to the purchaser of the stolen property. Consequently, the rightful owner can always recover stolen property, even if found in the hands of an innocent purchaser for value. This is what is characterized as a "void" title.

EXAMPLE: A, a thief, smashes the window of B's jewelry store and steals a watch which he sells to C, an innocent purchaser for value. B can recover the watch from C.

If, however, a seller is induced through fraud voluntarily to part with possession of and title to the goods, the perpetrator of the fraud acquires a "voidable" title, meaning one which is void so far as the fraudulent party is concerned, but one which becomes valid in the hands of an innocent purchaser for value, the underlying principle being that the party (seller) who has made commission of the fraud possible should bear the loss rather than an innocent third party.

EXAMPLE: A, by falsely representing himself to be the nephew of some prominent millionaire, obtains a watch from B on credit, which he later resells to C, an innocent purchaser for value. B, on discovering the fraud, wishes to recover the watch from C. He cannot. A's voidable title became valid in the hands of C, an innocent purchaser of the goods for value.

CHAPTER VI

WARRANTIES

Kinds of Warranties

A question which often arises in the sale of merchandise is just how far a salesman or agent of the selling house may go in representing his goods to the buyer without subjecting his employer to liability for a breach of warranty. It is a mistake to assume that the seller is not bound by any representation unless the terms "warrant" or "warranty" are expressly used. In fact, there may be a breach of an "implied warranty" without any express misrepresentation whatever having been made.

In other words, a warranty may be either express or implied. But in either case the warranty is a separate, independent, and collateral undertaking on the part of the seller for which the sale is the consideration.

Express Warranties

An express warranty is any promise or assurance made by the seller relating to the goods, if the natural tendency and actual result of such representation is to induce the buyer to purchase the goods. If the purchaser relies on his own judgment in selecting the goods, there is no warranty, even though the seller may have misrepresented them to such an extent as would otherwise constitute a breach of warranty.

> EXAMPLE: A buys goods from B, who assures A that the goods may be used for a certain purpose. If it later develops that the goods may not be satisfactorily used for that particular purpose, there has been a breach of warranty.

Distinction between Statement of Fact and Expression of Opinion

The seller must be careful to discriminate between a promise, or statement of fact, and a mere expression of opinion. The latter is not binding on the seller and constitutes what is commonly referred to as "puffing one's goods" or "sales talk." For example, statements by the seller as to the value of the goods, or to the effect that the goods "are the best on the market" would be construed as such.

The attitude of the courts, however, in construing such statements has been to hold the seller responsible for the language he uses and not to permit him to escape liability by claiming that he did not intend to convey the impression which his language was calculated to produce upon the mind of the buyer. That is, "the courts have in their later decisions manifested a strong disposition to construe liberally in favor of the buyer the language used by the seller in making any affirmation as to his goods, and have been disposed to treat such affirmations as warranties whenever the language would reasonably authorize the inference that the buyer so understood it."[1]

Distinction between Express Warranty and a Condition

There is a further important distinction, in legal effect, that is made between a condition, or promise which constitutes one of the terms or basis of the contract, and a warranty, which is, as previously stated, a collateral or subsidiary promise, in that a breach of the former entitles the party relying upon it to treat the contract as broken, whereas a breach of the latter gives rise merely to an action for damages.

Implied Warranties

The general rule in the law of sales is that of the old common law doctrine of *caveat emptor,* meaning "let the buyer

[1] 4 Met. 151, 155.

beware," when trading in the open market. The exceptions to this rule constitute what are known as "implied warranties," wherein the seller assumes the risk instead of the buyer.

An implied warranty may be defined as one which arises by operation of law and is not dependent for its existence upon any misrepresentation by the seller. In other words, there are certain implied warranties to which the seller is legally bound even though nothing was said about them at the time the sale was made. The following are the principal warranties that are implied in the sale of merchandise at common law:

1. That the seller has a right to sell the goods; or if it be a contract of sale, that he will have the right to transfer title when the time for delivery arrives.
2. That possession by the buyer shall not be disturbed by any claim made by others against the goods.
3. That the goods shall be reasonably fit for the purpose for which they are ordinarily used.

EXAMPLE: B orders of C, a leather dealer, a new leather fan belt for his automobile. Owing to the inferior quality of the leather used, the belt breaks. C is liable to B for damages. There has been a breach of the implied warranty that the leather belting shall be sufficiently strong and reasonably fit for the purpose for which it was to be used.

Sale of Goods by Description

In the sale of goods by description the purchaser does not even see a sample of the goods, and so it is only logical that the seller should be held to higher principles of business conduct than where the buyer actually sees the goods or a sample of them. This is at least the view reflected in section 14 of the Uniform Sales Act:

> Where there is a contract to sell or a sale of goods by description, there is an implied warranty that the goods shall correspond with the description and if the contract or sale be by sample, as well as by description, it is not sufficient that the bulk of the goods corresponds with the sample if the goods do not also correspond with the description.

Implied Warranties of Quality

The provisions of the Sales Act restrict the liability of the seller of merchandise, as concerns implied warranties of quality, to a greater extent than was true at common law. Section 15 provides:

> Subject to the provisions of this act and of any statute in that behalf, there is no implied warranty or condition as to the quality or fitness for any particular purpose of goods supplied under a contract to sell or a sale, except as follows:
>
> (1) where the buyer, expressly or by implication, makes known to the seller the particular purpose for which the goods are required, and it appears that the buyer relies upon the seller's skill or judgment, there is an implied warranty that the goods shall be reasonably fit for such purpose.
>
> (2) where the goods are bought by description from a seller who deals in goods of that description, there is an implied warranty that the goods shall be of merchantable quality.
>
> (3) if the buyer has examined the goods, there is no implied warranty as regards defects which such examination ought to have revealed.
>
> (4) in the case of a contract to sell or a sale of a specified article under its patent or trade name, there is no implied warranty as to its fitness for any particular purpose.
>
> (5) an implied warranty or condition as to quality or fitness for any particular purpose may be annexed by the usage of trade.
>
> (6) an express warranty or condition does not negative a warranty or condition implied under this act unless consistent therewith.

Sales by Sample

In the case of a contract to sell or a sale of goods by sample, section 16 provides:

> (a) there is an implied warranty that the bulk shall correspond with the sample in quality.
>
> (b) there is an implied warranty that the buyer shall

have a reasonable opportunity of comparing the bulk with the samples.

(c) if the seller is a dealer in goods of that kind, there is an implied warranty that the goods shall be free from any defect rendering them unmerchantable which would not be apparent on reasonable examination of the sample.

Warranty Not Available to Subpurchasers

It is settled law that the mere resale of a warranted article does not give the subpurchaser a right to sue the original seller for damages caused by defects either in the title or quality of the goods. This principle of law is apparently based on the theory that a warranty, like an insurance policy, must be construed as a contract of personal indemnity. However, a buyer who has bought goods with a warranty may recover damages which he has been compelled to pay a subpurchaser to whom the goods were sold with a similar warranty. In this way the original warrantor is in effect made liable in the same amount that he would have been had the warranty been held to run with the goods.

Oral Warranty Excluded by Written Contract

> Undoubtedly the existence of a separate oral agreement as to any matter on which a written contract is silent and which is not inconsistent with its terms, may be proven by parol, if under the circumstances it may properly be inferred that the parties did not intend the written paper to be a complete and final statement of the whole of the transaction between them. And when the contract itself upon its face is couched in such terms as import a complete legal obligation without any uncertainty as to the object or extent of the engagement, it is conclusively presumed that the whole agreement of the parties was reduced to writing (Greenleaf on Evidence).
>
> If the sale or contract to sell be within the statute of frauds, and if a note or memorandum be relied on as evidence of compliance therewith, such note or memorandum must also contain the express warranty, if there is one. Otherwise, evidence of such warranty will not be received. If, however, acceptance and re-

ceipt, or part payment, be relied on as evidence of compliance with the statute, oral evidence of an express warranty is then admissible.[2]

Implied Warranty Not Excluded by Written Contract

The obligation attached to a contract for the sale of goods cannot be changed by the mere fact that the contract has been reduced to writing. The writing, it is true, is deemed to express the whole agreement of the parties, but since this particular liability arises from the nature of the transaction and the relations of the parties, without express words, or even actual intention, it remains a part of the seller's obligation unless in some way expressly excluded. All implied warranties therefore attach to a written as well as an unwritten contract of sale.[3]

Remedies for Breach of Warranty

In most states a buyer to whom title has passed cannot rescind a sale for breach of an express warranty, but has a right of action for damages resulting from the breach. In other states he may do either—rescind the sale, or keep the goods and sue for damages for the breach of warranty.

For the breach of an implied warranty the buyer may at his election either: (1) rescind the sale and recover the price paid, or (2) accept the goods and sue for damages for the breach.

If he elects the former right, he must notify the seller of his intention to do so promptly, or within a reasonable time and if the seller refuses to accept the goods when tendered back, the buyer may hold them as bailee for the seller until an adjudication has been made as to their respective rights.

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2 Irwins, Summary of Sales, p. 89.
3 *Ibid.*, p. 90.

CHAPTER VII

LAWS GOVERNING THE VALIDITY OF SALES CONTRACTS

Transitory Causes of Action

Suits on contracts constitute what are known as "transitory causes of action," by which is meant that it is not necessary to bring suit on a contract within the state and county in which the contract was entered into, but that such actions may be brought and enforced in any state, provided proper service may be obtained upon the defendant within the state in which the action is brought. And when such an action is brought in a state other than that in which the contract was entered into, the plaintiff is not enforcing a foreign law, but rather a foreign-acquired right, which is transitory and can therefore be enforced anywhere.

Contracts to Sell

Where a contract to sell merchandise is made in one state to be performed in another state, the general rule of law is that the validity of the contract is determined in accordance with the laws of the place of its creation, or the state in which it was entered into (the *lex loci contractus*); whereas the question of performance of the contract is to be determined in accordance with the laws of the state in which it was to be performed.

In this connection it may be noted that the Statute of Limitations affects the remedy and not the right of action, and it is, therefore, the statute of the state in which the action is brought rather than that of the state in which the contract was entered into which governs in such cases, as, for example, a

contract to sell made in New York to be performed in Connecticut. Assuming the Statute of Limitations on such causes of action is 5 years in New York and 10 years in Connecticut, the fact that the statute had run in New York where the contract was made would not affect or bar the prosecution of the cause of action in Connecticut. And if the Statute of Limitations on such cause of action was 20 years in Oklahoma, one would still have an additional 10 years in which to recover on his contract by bringing his suit in Oklahoma.

Contracts of Sale

When one is dealing with contracts of sale the law of the state in which the property is located determines the passing of title, and such contracts are therefore enforced in accordance with the laws of the state wherein the goods or merchandise are located.

Uniform State Laws

In the United States a unique legal system has been established in that certain powers of sovereignty are vested in the federal government, while others are reserved to the respective states. Those reserved to the federal government are those set forth in the United States Constitution, which has been construed to exclude all legislative powers not thus reserved to the federal government.

This, of course, is simply another way of saying that the various states are independent legal units and sovereignties unto themselves, except in so far as their legislative powers are restricted by the federal Constitution. And it is due to this fact, together with the additional fact that the conditions which the different state laws are enacted to govern, vary, that the laws of the various states are not more uniform. In other words, it is this multiplicity of jurisdictions that is primarily responsible for the great diversity in the decisions and statutes of the various states.

In so far as conditions of a strictly local or state nature are concerned, no great practical inconvenience results from it, but the inconvenience, confusion, and impracticability resulting from this divergency of state legislation to a merchant doing a national or interstate business is obvious, as it means that his rights under precisely the same set of circumstances may be quite different in one state from what they are in another, depending entirely upon the state within which his cause of action has arisen. And it was with a view to overcoming the inconvenience and confusion resulting from this unnecessary, but nevertheless existing, variance in the state laws concerning commercial trading, that a national Commission on Uniform State Laws was appointed in 1892.

National Commission for Uniform State Legislation

The primary object of the commission is not to change the laws of any particular state or states, but to codify the best features of all into one set of general rules or principles, and thus bring about a greater uniformity of state legislation on the subject under consideration for practical purposes, since this end is unattainable through the federal government because of constitutional limitations.

The manner in which this object is accomplished is by means of committees appointed by the American Bar Association to formulate a set of general rules or legal principles which shall govern and regulate the rights of the parties growing out of some particular phase of commercial trading. This set of rules, or code, is then submitted to the American Bar Association for approval, which in turn recommends it to the legislatures of the various states for enactment as one of their state statutes. Assuming their recommendation to be acted upon favorably by all the state legislatures, uniform legislation throughout the United States, in so far as that particular subject is concerned, would thereby be obtained.

A menace to the accomplishment of this purpose, however,

lies in the wide divergence of the judicial interpretation of the provisions of the statute, due to the attempt on the part of the local courts to perpetuate former established principles. This tendency in some instances has been sufficiently prevalent to defeat the real purpose of uniform state legislation, and in an effort to overcome it a Committee on Uniformity of Judicial Decisions has been appointed to tabulate the decisions rendered under the commercial acts, and which is at all times made available to the courts. In this way it is hoped to bring about a uniformity of "judge-made law" as well as statute law, for it is realized that until this is accomplished there can be no actual uniformity.

Whereas no open resistance has been manifested by the states against such uniform legislative measures, practical difficulties which have been encountered and have had to be overcome, have rendered the task of securing the adoption of such acts difficult. However, the need for such uniformity in commercial legislation unquestionably exists and the modern legislative tendency is toward that end. As James Bryce in his "Studies on Jurisprudence" has said: "The more any department of law lies within the domain of economic interest, the more do the rules that belong to it become the same in all countries, for in the domain of economic interest Reason and Science have full play."

Uniform State Laws Enacted

Thus there are two ways in which uniform legislation may be obtained throughout the United States:

1. By federal enactment within the legislative powers of Congress, as the Bankruptcy Act.
2. By state enactment of a uniform statute by the legislatures of the various states, as the Negotiable Instruments Law.

The Commission on Uniform State Laws held its first meeting in 1892, and since then has approved and recom-

mended for adoption some eighteen uniform acts, the two most important of which are the Negotiable Instruments Law, the oldest and most widely adopted of the uniform acts, drafted in 1896; and the Uniform Sales Act, drafted in 1906. The former has been enacted in all the states and territories except Georgia and Porto Rico, whereas the latter has been enacted in the following states:

Arizona	New Jersey
Connecticut	New York
Idaho	North Dakota
Illinois	Ohio
Iowa	Oregon
Maryland	Pennsylvania
Massachusetts	Rhode Island
Michigan	Tennessee
Minnesota	Utah
Mississippi	Wisconsin
Nevada	Wyoming

Copies of both of these acts should be in every credit department for reference purposes. Other such uniform acts which have been recommended and approved in this manner, are the Uniform Bills of Lading Act, Partnership Act, Conditional Sales Act, Warehouse Receipts Act, Stock Transfer Act, and the Workmen's Compensation Act.

PART III

SAFEGUARDING PAYMENT IN THE SALE OF GOODS

CHAPTER VIII

ANALYSIS OF MERCANTILE CREDIT

Risk in Credit-Granting

Speaking generally, the merchant who discounts his bills or pays cash for his goods is using the profits from past business to trade on, whereas the man who buys on credit may be said to be trading on an anticipated profit of the future. Consequently, it becomes necessary for the merchant who sells on credit to forecast as accurately as possible, through the eyes of his credit department, the conditions which are to produce these profits. In other words, there is more or less risk involved in all credit transactions and it is the difficult task of the credit man to determine in just what degree that risk is present in any given case.

To be able to do this requires special qualifications of both a personal and technical nature—qualifications which enable him to analyze and estimate correctly the mental, moral, and financial assets of an applicant in such a way as to establish his financial or credit responsibility. Yet, as has been previously said, there is no mystery connected with the duties of a credit man, and no secret formula need be used in the practice of what has been termed the "new profession."

In the first place we must understand just what a "line of credit" means or represents, as the situation with which the first half of our general subject is concerned, stated briefly, is this: A house wants to do business with your company—how are you to determine whether or not you will extend them a line of credit, and, if so, the credit limit that is to be placed on the account?

As we have already seen, the extension of mercantile credit actually amounts to a loan of capital in the form of merchandise on the part of the creditor. So in extending mercantile credit the real problem that presents itself is: How are you to determine whether or not you will loan a merchant or business firm a part of your capital in the form of goods?

Confidence in Borrower

To take first a personal illustration, assume that an individual has only $10 to loan, and three friends, A, B, and C, each of whom wishes to borrow it. With the choice of selecting one of three, what factor or factors would naturally determine which one he would select in preference to the other two? Would it not be the likelihood or probability of repayment? In other words, he would not loan it to any one of the three friends if he did not think it would be repaid. If he did decide to loan it to one of them it would at least mean that he felt confident that the friend would repay him. Or, to put it in another way, before he would part with his $10 he would have to have confidence in the party to whom he was loaning it.

If, then, there is no substantial difference between the case of his loaning $10 of his personal capital, or money, to a friend, and a business house loaning a part of its capital to a customer in the form of goods or merchandise, it therefore follows that just as he would first have to have confidence in the party to whom he was to loan his $10, a business house must first have confidence in the customer, or applicant for credit, to whom it is going to loan a part of its capital in the form of merchandise; that is, before it will extend him credit.

Factors upon Which Confidence Depends

The next question is: How is the lender to determine whether or not confidence may be reposed in an applicant for credit? To continue the analogy the question may be asked: What principal factor or factors would be taken into considera-

tion in deciding whether or not he should loan $10 to A, B, or C? What kind of a fellow would the borrower have to be? What attributes or qualities would he have to possess?

If the lender is to prefer one over the other two, it is obvious that some mental process of elimination must be carried out before such a selection can be made, and the incidental process or line of reasoning may be either crude or scientific. In fact, the only real difference that exists between the process of elimination that would be carried out by an individual in extending a personal loan and that of a credit man in extending a line of credit is that, whereas it is likely to be of a rather crude and more or less subconscious nature in the former case, in the latter it will be a more scientific and conscious process, carried out by the credit man in accordance with well-defined rules and principles. But in both cases the object and purpose of going through such a process of elimination is the same, namely, solely to determine the apparent likelihood of the recipient of the loan fulfilling his promise to pay later. So the next step in our analysis of mercantile credit is to ascertain the factors upon which that likelihood naturally depends.

To complete our analogy, let us further assume that: A was honest, but had no money and was not working; B was dishonest, but a man of limited means, temporarily out of funds; C was honest, had no money, but was working and earning a good salary.

Now let us analyze and apply this information relating to A, B, and C, each of whom is equally desirous to borrow the $10.

1. When we say A is "honest," we mean that if he has $10 on the day he promised to pay you back, there is every reason to believe that he will willingly do so.

"Good character" = Willingness to pay *if he can*

2. B is dishonest, but has sources of future income, which means that he very likely will be *able* to repay as he promised, but, being dishonest, it is more or less doubtful as to whether

he would be willing to pay if he thought he could successfully evade it.

3. C is honest and is working, which means that he will not only be willing to repay you if he can, but that he will very likely be able to do so because he is earning a salary, or has the capacity to earn the money with which to repay you.

The Credit Equation

1. A, with good character alone, is not a good credit risk. One cannot pay one's bills or finance a business merely with good intentions.

2. B, with sufficient capital, but of questionable character, is not a good credit risk. To loan money to such a man would be almost equivalent to purchasing a lawsuit.

3. C, with good character and earning capacity, would be a good credit risk. Such a man would not only be willing to repay the lender if he could, but also would possess the means of accomplishment necessary to fulfil his promise.

If the extension of mercantile credit is substantially analogous to a personal loan of money, or capital, it must follow that the same three factors are to be taken into consideration by a business house in extending credit as by an individual in extending a loan. To express the same thought in other words, the degree of confidence that may be placed in an applicant for credit is measured by what are known and commonly referred to by credit men as the "three C's of credit"—character, capital, and capacity.

We can therefore state the "credit equation" in the following form:

$$\text{Character} + \text{Capital} + \text{Capacity} = \text{Unlimited credit.}$$

Credit Factors Analyzed

So in extending a concern a line of credit a lender expresses his confidence in its ability and willingness to meet whatever obligations it may incur up to a certain amount, known as its "credit limit," which is based primarily on three elements, which are:

1. The character of the interested parties, connoting their willingness to pay, as signified by their:
    (a) Moral principles.
    (b) Habits.
    (c) Antecedents.
    (d) Reputation.
2. Their capital, or available resources with which to pay, as shown by the relation existing between their business assets and liabilities as set forth in a financial or property statement.
3. Their capacity or ability to succeed, as manifested by:
    (a) A record of their business experience.
    (b) Skill manifested in overcoming business difficulties.
    (c) Mental, moral, and physical fitness for the business in which they are engaged.

In other words, if we had but to ask for the information, we would want to know everything on which depends a concern's business standing. In fact, the information which a credit department desires is literally unlimited—any fact connected with the individual's past record, condition of his business, his personal habits, integrity, domestic life. Nothing is too trivial to be of interest as bearing on the case, and if such complete data were always available, the work of the credit man would be a joy. Unfortunately, however, the limited data oftentimes placed at his disposal makes it necessary for him to depend largely upon his personal experience and general knowledge of the business in estimating the risk involved.

These three elements, then, constitute the working basis for credit-granting, and when one has satisfied himself as to the character of the men he is to deal with, their available resources and prospects for success, he is in a position to estimate the risk involved in extending them a line of credit. We shall therefore proceed to examine and discuss each element separately, and later consider their relation and relative importance in arriving at a final decision.

1. Character

Several years ago the late J. P. Morgan was called to testify before a special committee of Congress charged with the investigation of certain economic conditions existing at the time [1] and in the course of the examination he was asked relative to a loan of a million dollars made to a certain party. "On what security was the money advanced, Mr. Morgan?" "No security whatever," he replied, "for he had none to put up, but merely on the strength of his character."

This concrete example well serves to illustrate the practical importance of this element in obtaining, or granting credit, for it can be safely assumed that a man of good character can be depended upon to pay his bills whenever possible. In other words, the moral risk counts for more than anything else, or, "Collateral can never take the place of character."

Just what is meant by "character" when referred to in connection with "credit"? We mean a man's willingness and inclination to pay his bills, which in turn is significant of and based on the soundness of his moral principles, for personal actions and conduct undoubtedly serve as a reliable index to one's character.

Furthermore, a man's character does not undergo any great change overnight, so that the investigation should always include a customer's past business history, in order to ascertain if he has ever been associated with any questionable transactions.

While experienced credit men differ in their estimate of the relative importance of this element of character, suffice it to say that even to the few who do not consider good character a *sine qua non* to the extension of credit—adverse information on this score is at least regarded as a danger signal, for capital and capacity count for little when a clever rascal starts out with the deliberate intention to "beat" his creditors.

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[1] Pujo Money Trust Investigation.

2. Capital

We have just observed how important it is, in extending credit, to consider first a credit-seeker's willingness to pay. But were a business house to make a practice of accepting the will for the deed, it would soon find itself saying "Good morning" to the district referee in bankruptcy. Hence the further necessity of considering the probability that he will be able to pay—his available means, or working capital.

In other words, assuming a merchant to be of good character and proved ability, there is still an element of risk in selling him goods on credit when the actual means of payment is lacking at the time the sale is made, and the granting of credit under such circumstances constitutes what is known in credit terminology as a "moral risk," meaning the risk involved in extending credit to merchants whose only shortcoming is a lack of capital, on the assumption that an honest man would not incur a debt unless he could see his way clear to pay it when due.

The amount of actual capital invested in the business means little to the credit man, as it may be so tied up in bad accounts or unsalable merchandise that he has not sufficient resources available to meet his current expenses. It is rather the manner in which a merchant handles his capital that has the most important bearing on his financial standing, for just as a good housekeeper can run a house on what a poor one wastes, a thrifty merchant with small capital can so manage his business and regulate his finances as to constitute a safer risk than one with a larger capital but less foresight.

The property or financial statement showing the relation existing between the assets and liabilities of the business furnishes the most satisfactory source of information in this connection. The analysis of such statements with a view to determining the financial responsibility of the applicant will be discussed later (see Chapter X, "Preparation and Analysis of Financial Statements").

3. Capacity

Just what is meant when we ask if a man has capacity or ability? We mean: Is he a good business man—has he the necessary equipment, mental and physical, to conduct his business successfully, including such factors as education, health, age, experience, and initiative? In other words, measured by his personal efforts, has he demonstrated his ability to assume successfully the responsibility incidental to the management of a business?

There is certainly an element of truth in the saying, "A fool (though honest) and his money are soon parted," which is simply another way of saying, that to make a success in business one must possess a certain amount of ability. The capacity may be "native," in the sense of having been inherited from a superior parentage, or acquired by special training or business experience; but in either event the result is the same, in that it tends toward the development of what might be termed an intuition or aptitude for doing the right thing, in the right way, at the right time.

Moreover, there is also undoubtedly a close relationship existing between capacity and what is generally meant by the very common, abstruse term "efficiency," which partakes somewhat of a cause-and-effect relation. Capacity connotes the *force* which sets the machinery in motion and guides it along a prescribed course, whereas efficiency is the *result,* or practical effect of the adjustment, for when we ask whether so and so or such and such an organization is efficient, what we generally mean is: Has the end in view, or the object sought, been accomplished or attained with a minimum of time, effort, and expense?

What is the test of the presence of this element in analyzing an application for credit? It may be said to be reflected in the extent to which modern business methods have been adopted in the management of the applicant's affairs, and the skill he has demonstrated in overcoming business difficulties

encountered—evidence of the fact that he knows his business—as contrasted with an unmethodical and slipshod manner of conducting the business, coupled with an unprogressiveness and lack of initiative, which manifest an inability to keep abreast of the times.

As to the importance of the element of capacity, in the last analysis it simply amounts to this—other factors being equal, the healthy, forceful, broad-minded, and aggressive man is more likely to succeed than one who is sickly, dull mentally, narrow-minded, and easy-going.

Relation and Relative Importance of the Credit Factors

Together the three elements of character, capital, and capacity constitute the standard whereby every applicant for credit is measured in determining the risk involved in extending him credit, and when the credit man has analyzed the situation from these three points of view, he is in a position to decide whether his standing is such as to justify the company selling him on open terms.

However, a merchant need not possess all three of these business assets to obtain a reasonable line of credit from even the most conservative houses; otherwise the volume of trading in the commercial world today would not amount to a third of what it is, for only a relatively small percentage of applicants are blessed with the possession of all three factors, whereas approximately 90 per cent of our commercial transactions are based on credit.

But credit men do differ in estimating the relative importance of the three elements, i.e., where one lays greatest stress on character, another may judge a risk solely by the customer's financial responsibility, whereas a third may be guided principally by the ability he has manifested in the management and development of his business. Hence the classification of credit men as being either "materialists"—those who insist upon some tangible assets (capital) being present, or "idealists"—those

who lay greatest stress on the personal factors, character and capacity, which cannot be measured in dollars and cents.

This division of opinion among credit men may be attributed largely to a difference in the results of their actual experience, for credit men are only human and it is but natural that they should be influenced greatly by the success or failure that has attended their risks and out of which their present policy has been developed. In other words, if one credit man has suffered his greatest losses through a reliance on capital alone, it would tend to increase his respect for the other two factors; whereas another whose company has found it most profitable to insist upon tangible assets on which to base a line of credit, would quite naturally consider capital the most important element. Thus actual experience is one way to determine the relative importance of the three factors.

Another way to measure their relative importance is based on statistics compiled yearly by the mercantile agencies, showing the causes of business failures within the previous year. For instance, if the chart shows 12 per cent of the business failures were due to fraud, 20 per cent to lack of capital, and 40 per cent to incompetency, it is helpful to a credit man to know that whereas one out of every ten failures was due to fraud, two were due to a lack of capital, and four to a lack of ability.

Character Most Important Factor

A man may have ability, he may be honest, he may have capital, and still fail; but the consensus of opinion of experienced credit men seems to be that the element of risk involved is reduced to a minimum when both good character and capacity are present, and it is seldom that an applicant possessing both is deprived of the benefit of a reasonable line of credit, for it would be strange indeed if such a man with the assistance of capital, in the nature of the credit extended him, did not succeed. In other words, theoretically at least, char-

acter + capacity = the best combination, because once such a merchant is supplied with capital in the form of merchandise, he has all three elements of credit; whereas one possessing character and capital could not be supplied with business capacity.

Furthermore, character, or integrity, may be regarded as the most important of the three factors, for given a man with ample resources with which to pay, and apparently capable but of questionable character, and you have a credit risk in every sense of the word. Or, as put by the late J. P. Morgan: "No matter how great may be the financial resources of a growing business, without character it cannot expect credit."

One writer in commenting on the relative importance of the three factors summarized his conclusions in this manner:

> A combination of small capital, good character, thrift and industry is a much better groundwork for a line of credit to a customer, than is large capital, indifferent character and habits, and loose unbusinesslike methods. It goes without saying that adequate capital, unimpeachable integrity, and strict business methods constitute the ideal risk.

He might also have added that where favorable information on any one of these factors is lacking, time and experience alone will determine to what extent the account is desirable.

Business Conditions

To succeed as a credit executive a man should at all times keep in close touch with general business conditions. No period in our commercial history could better illustrate the necessity of this than the readjustment period of 1920-1921, because it clearly and conclusively demonstrates that business concerns which succeed well enough in ordinary times may be utterly unable to cope with competitive conditions under adverse business conditions, and it was the credit men who were able to foresee the change that has taken place in economic conditions who suffered the least.

This simply means that whereas the points of inquiry in investigating a merchant's credit responsibility remain the same at all times, the information that is obtained must be construed in the light of prevailing business conditions.

Attitude of the Credit Man

Finally, before leaving this subject, let us consider what should be the proper attitude of the credit man in extending credit to the trade, for on this largely depends not only the volume of business transacted but the popularity of the house as well.

In the first place, it goes without saying that in these days of keen competition and business rivalry, a liberal policy in extending credit is absolutely essential to the healthy growth, expansion, and progress of a business; and by "liberal" is not meant a loose or reckless policy, but rather a prudent, open-handed policy, tempered with due discrimination and a proper regard for those conditions and circumstances which determine the degree of risk involved, bearing in mind all the while the ultimate object or purpose of the credit man—to sell all the goods he can with the least possible percentage of loss.

Such a policy is made possible and at the same time profitable by the fact that most business men are honest, some inherently and others because they realize it is the best policy, leaving but a small percentage of dishonest merchants in business and consequently making it safe for credit men to proceed on the assumption that his customers will pay if they can, even though, as an abstract proposition, they have no definite moral conception of honesty or commercial integrity.

It therefore follows that to carry out such a policy successfully, a credit man must have unlimited faith in humanity and the capacity to develop friendly and confidential relations with the trade, for the head of the credit department of a prosperous business concern is no place for a man that is narrow in his views, naturally incredulous, or parsimonious in

his dealings, because a cramped credit policy is bound to show itself in a decline in the growth and progress of business.

Summary

The following may be stated, in summarizing the information developed in this chapter:

1. Extending mercantile credit amounts to loaning a part of the business capital in the form of merchandise.
2. Before a man or business house loans its money or capital it must have confidence in the party that is to receive it.
3. Confidence depends upon and is measured by the three C's of credit—character, capital, and capacity.

Or, expressed in a sort of perverted syllogism:

1. Extension of mercantile credit depends on confidence in customers.
2. This confidence depends upon the likelihood that they will pay as promised.
3. Likelihood that they will pay as promised depends upon character, capital, and capacity.
4. Therefore mercantile credit, in the last analysis, depends upon and is measured by:

   Character
   Capital
   Capacity

When we have reached that stage in our investigation, the next problem that confronts us has to do with the manner and means whereby we are to find out or ascertain whether an applicant for credit is of good character, and whether or not he has any capital or business capacity. And that brings us to our next subject, "Sources of Information."

CHAPTER IX

SOURCES OF CREDIT INFORMATION

Facts as an Aid to Judgment

Credit men are no different from men engaged in other fields of business when it comes to arriving at decisions. Good judgment on any question consists in first securing all the relevant information about it one can, and then assigning the correct weight and importance to each fact. In other words, a credit man can have no confidence in a judgment based on insufficient or unreliable data.

The first requisite, then, for making good decisions is a trustworthy method of ascertaining facts on which to base a decision.

The Mercantile Agencies

Now that we know the nature of the information we want, let us consider the various sources available, and means employed, to obtain it.

The standard agencies, the Bradstreet Company, and R. G. Dun and Company, undoubtedly constitute the most popular source of credit information, and it is generally through either or both of these channels that the credit man starts his investigation, particularly for enlightenment as to the moral and mental make-up of the applicant. Then, if additional information is desired concerning his finances, a property statement may be asked for.

Both agencies publish quarterly a book of ratings containing the name and business address of every individual, firm, or corporation engaged in business (they supply information on mercantile companies only) in the United States

and Canada, with two ratings—a capital rating and a credit rating—the former intended to show the financial strength of the concerns, and the latter the agency's opinion as to the degree of confidence that may safely be reposed in them, based on their general policy of trading and particularly the manner in which they meet their bills. They are now each reporting on over two million firms in business. This data is checked over, revised, and republished four times a year, but a subscriber cannot hold the agencies responsible for losses resulting from reliance on their information because, theoretically, they are acting as his agents. Nor do they guarantee the veracity or accuracy of the information submitted in their reports.

Organization of Agencies

The general organization, or *modus operandi,* adopted by both agencies is quite similar, as each maintains a central office in New York and district managers in charge of the sectional offices established throughout the country, each of which is supposed to be self-supporting.

Three kinds of investigators are employed: (1) traveling reporters, (2) local representatives, and (3) attorneys and other correspondents. Each is assigned so many accounts to investigate and "write up" after the information has been checked up through court records, state reports, insurance companies, etc., and inquiries made among the trade. It is on the facts gained from these sources and contained in the written reports that the ratings of the concerns are based.

Ratings

Both agencies aim to give substantially the same information, but each uses a different "key"—so familiar to credit men that it is seldom referred to—to indicate their ratings.

The ratings are determined by officials of the company, not by the investigators, and, as has already been pointed out, consist of two parts—a capital rating and a credit rating. The

BRADSTREET

	Estimated Wealth		Grades of Credit		
G	$1,000,000 and above		AA	A	B
H	500,000 to $1,000,000				
J	400,000 to	500,000	A	B	C
K	300,000 to	400,000			
L	250,000 to	300,000			
M	200,000 to	250,000			
N	150,000 to	200,000			
O	100,000 to	150,000	B	C	D
P	75,000 to	100,000			
Q	50,000 to	75,000			
R	35,000 to	50,000			
S	20,000 to	35,000	C	D	E
T	10,000 to	20,000			
U	5,000 to	10,000			
V	3,000 to	5,000	D	E	F
W	2,000 to	3,000			
X	1,000 to	2,000	D	E	F
Y	500 to	1,000	E	F	
Z	0 to	500			

former is supposed to represent the true net worth of the business, whereas the latter represents the grade of credit to which the merchant is in the agency's opinion entitled, with particular regard as to the manner in which he pays his bills.

The two ratings are absolutely distinct and bear no relation to one another; for example, any suspicion that might attach to a merchant's character or manner of trading would not affect his capital rating to any extent whatsoever, but only his credit rating.

Special Reports

In addition to the ratings contained in the rating books, the detail information on which the ratings are based is also

R. G. DUN & Co.

	Estimated Pecuniary Strength		General Credit			
			High	Good	Fair	Lt'd.
AA	Over $1,000,000		A1	1	1½	2
A+	$750,000 to	$1,000,000	A1	1	1½	2
A	500,000 to	750,000	A1	1	1½	2
B+	300,000 to	500,000	1	1½	2	2½
B	200,000 to	300,000	1	1½	2	2½
C+	125,000 to	200,000	1	1½	2	2½
C	75,000 to	125,000	1½	2	2½	3
D+	50,000 to	75,000	1½	2	2½	3
D	35,000 to	50,000	1½	2	2½	3
E	20,000 to	35,000	2	2½	3	3½
F	10,000 to	20,000	2½	3	3½	4
G	5,000 to	10,000		3	3½	4
H	3,000 to	5,000		3	3½	4
J	2,000 to	3,000		3	3½	4
K	1,000 to	2,000		3	3½	4
L	500 to	1,000			3½	4
M	Less than	500			3½	4

The lines which separate the different grades of credit indicate the ratings ordinarily required by credit insurance companies before they will indemnify the shipper against loss.

available to subscribers in the form of special reports, submitted on request and for a very nominal sum, except when the information is confidential, being then too detrimental to be spread broadcast. It is then necessary to call at the office for it. The sale of these special reports supplies one of the main sources of revenue for the agencies.

Request for such reports must be made on special blanks supplied subscribers by the agency, and the information asked for is submitted with the understanding that it is to be used for strictly legitimate mercantile purposes and regarded as strictly confidential. The reason for this is twofold: (1) to prevent non-subscribers from participating in the benefits of

the service, and (2) to guard against the use of the information for some ulterior or malicious purpose.

The contents of these reports includes detailed information bearing on the character of the interested parties, as judged by their past history, life, habits, and reputation; on their ability as judged by their past business record and the present condition of their affairs; and on their capital, both inside and outside the business. The conclusion of the whole report consists of a general statement in which the agency presents its opinion or judgment as to the net worth of the business, the credit limit which should be placed on the account, and any other features bearing on the risk involved.

Reports of failures, fires, foreclosures, assignments, and other important changes in the business are supplied to subscribers who have asked for special reports, voluntarily and without charge, for several years after the report has been requested.

Both agencies also publish weekly trade reports giving a current summary of business conditions existing throughout the country, based upon the reports they receive from their investigators, the idea being in keeping with their policy to keep abreast of all progress incidental to the granting of mercantile credit.

Criticisms

While the service of these commercial agencies is well-nigh indispensable to the commercial world, there are ways in which the service could be improved and made more satisfactory to credit men. Some of the criticisms are manifestly unjust, but others are well taken and the defects will undoubtedly be remedied and corrected in time:

1. The agencies have been asked to indicate which of their ratings are based on signed financial statements, for occasions arise when this additional information in itself might suffice in the opinion of the credit man to justify filing an otherwise

doubtful order, as there is no doubt that a man will be more cautious as to the truthfulness of what he puts down in black and white than as to what he passes on to some reporter by word of mouth as casual information.

Their failure to comply with this request is difficult to explain, in view of the fact that the percentage of property statements contained in their special reports has been estimated to be between 60 and 70 per cent, and is increasing from year to year.

2. The agencies are also frequently criticized because of misleading information and inaccuracies occurring in their reports, but the writer believes an investigation would develop that the percentage of error is surprisingly low rather than exceptionally high, based on the number of concerns on which the agencies report. Of course the agencies are not infallible, nor can they ever attain absolute perfection in their reports or ratings so long as they have to depend upon human effort for their information. Then again, it must be remembered that they have no means to compel a business man to give them data about his business. In such instances it is necessary for them to depend on outside sources for their information, and with credit men holding orders pending receipt of their reports, they often do not have sufficient time to make as careful and thorough an investigation as they otherwise would.

3. The fact that their reports contain no ledger information affords no justifiable ground for criticism, as it simply does not constitute a part of the service, and it is not intended for the credit man who must have actual ledger data before passing an order. Such information, while highly desirable and greatly in demand by credit men, must be obtained through other sources, and the agency should not be criticized for failure to do something entirely without the scope of its service.

4. The factor concerning which it is most difficult to obtain satisfactory information from the reports of the agencies has

to do with the practice of trade abuses, because such practices do not readily come to their attention.

5. To just what extent and in just what manner the agencies would justify the lack of uniformity in their reports is problematical, but there is undoubtedly room for improvement in the manner in which their data is presented, that is, from the credit man's point of view—a shortcoming as to form rather than substance, and one easily remedied.

6. Finally, their special reports are criticized on the ground that they are not always up to date—the data is not fresh. A report is revised twice a year; but suppose a merchant inventories his stock but once a year, say in June, submits these figures to the agency reporter when he calls the following December, and they are later submitted in a special report requested in May. The figures are then approximately a year old.

Assuming the necessary data available, the ideal agency report purports to submit a complete and accurate record of the following:

The merchant's antecedents.
His character.
His habits.
His business history.
His signed property statement based on a recent inventory.
Trade reports about him.
His fire record.
Ratings assigned to him.

Taken by and large it is safe to say that the credit man receives greater value in return for the money expended in agency service than he does from an equivalent amount expended for any other source of credit information. The value of these agencies in credit-granting may be more clearly appreciated, perhaps, if credit men should endeavor to contemplate the situation that would exist if this service were

suddenly discontinued. What other source of credit information could be turned to as a satisfactory substitute?

Legal Aspects of Agency Service

The precise legal relation existing between the mercantile agency, subscriber, and merchant, and the rights of action growing out of the relation, has been the subject of considerable litigation in the past, but the difficulties presented have since been practically set at rest by more recent decisions developing the general doctrine that "a statement made to one person with the expectation that it will be communicated to, and acted upon by, another, is the same as if made directly to the latter."[1]

Specific cases in point have held that "one who makes a false statement to a mercantile agency as to his financial status is equally liable to a subscriber to the agency to whom they report it, and who thereupon relies to his injury and to the same extent as they would be liable had the statements been made originally, directly to the party injured."[2]

"If the statement made by the merchant to the agency is changed by the latter, the merchant is not liable."[3]

In the case of the Cortland Manufacturing Company v. Platt [4] it was held that a merchant who had made a true statement to a commercial agency was not bound to give notice of any change in his circumstances short of actual or imminent insolvency.

As for the liability of the agency in furnishing information to the subscriber, it has been held, that:

> One who undertakes to furnish information as to the credit of individuals or corporations is liable, in the absence of an express contract to the contrary, for the negligent performance of that contract.[5]

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[1] Iasigi v. Brown, 17 Howard 183; McKenzie v. Weineman, 116 Ala. 194; Bradley v. Bradley, 165 N. Y. 183.

[2] Fecheimer v. Baum, 37 Fed. Rep. 167; Lindauer v. Hay, 61 Iowa 663; Salisbury v. Barton, 63 Kans. 552.

[3] Wachsmuth v. Martini, 154 Ill. 515.

[4] 83 Mich. 419.

[5] People v. May, 147 N. Y. 487.

and that:

> A contract between a commercial agency and its subscriber does not release the agency from gross negligence in falsely representing that it had investigated a prospective customer upon the subscriber's request.[6]

In a Pennsylvania case, it was held that:

> Where a person about whom an erroneous statement was made by a mercantile agency, is insolvent, the subscriber who has sold him goods on the faith of the statement, need not sue such insolvent before bringing suit against the agency.[7]

The courts also seem to have drawn a distinction between credit information interchanged between merchants, and statements containing information of the same nature made by a commercial agency. In the first place the general rule has been established that:

> Words imputing to one engaged in business, where credit is essential, non-payment of debts, or actions tending to lessen its credit responsibility, are libelous per se.[8]

An apparent exception to this general doctrine is:

> Where one to whom an inquiry is addressed regarding another communicates bona-fide and without malice, to the inquirer facts regarding the one inquired about, the communication is "privileged"; and hence one is justified in giving in good faith his opinion of the integrity and standing of a "tradesman" in response to an inquiry concerning him.[9]

However, in an Idaho case it was held:

> The report of a mercantile agency to its patrons on the financial standing of a business concern is not a privileged communication.[10]

In another case it was held:

> A mercantile agency must answer for any libelous publication concerning a person's credit.[11]

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[6] Munro v. Bradstreet, 155 N. Y. Sup. 833.
[7] Crew v. Bradstreet Co., 134 Pa. 161.
[8] Stannard v. Wilcox, 118 Md. 151.
[9] Melcher v. Beeler, 48 Colo. 233.
[10] Pacific Pkg. Co. v. Bradstreet, 25 Idaho 696.
[11] Denney v. Northwestern Credit Assn., 55 Wash. 331.

As to the length of time these statements remain in effect, in Sharplin v. Gummy,[12] it was held that the plaintiff was not justified in relying on a statement made 2½ years previous to a commercial agency, and in a later case, Treadwell v. State,[13] it was held that a statement made 60 days previously could not justifiably be relied on. While this would seem to be a rather extreme or hard case from a creditor's point of view, with the marked development in the efficiency of agency service, and in view of the rapid change in business conditions, the tendency of the law in this connection seems to be to restrict the length of time during which such statements may be relied and acted upon by creditors with legal protection.

Interchange Bureaus

The mercantile agencies purpose to tell whether or not a man *can* pay, but how much more helpful it would be to know that he actually *does* pay. In other words, suppose A wishes to do business with us and it will require a credit line of $5,000 to carry the account. We ask for agency reports and they tell us that A is of good repute, has been in business four years, owns the building he occupies, and is apparently enjoying a successful business. How much more helpful it would be to know that Jones and Company and Smith and Company, both equally conservative in extending credit, have been selling A as high as $5,000 worth of goods for some time past and payments have always been satisfactory. Of course, there is but one way in which this information could be obtained—by examination of A's account on the ledgers of Jones and Company and Smith and Company, and it was the great demand for this accurate information that has given rise to the development of what are known as "credit interchange bureaus," which serve as a medium through which ledger data is exchanged among merchants.

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[12] 168 Pa. 199.
[13] 99 Ga. 779.

In this connection we shall discuss: (1) the theory on which the service is based, and (2) its value as a source of information to the credit man.

THEORY OF SERVICE. The service is based on a system of reciprocity and co-operation of merchants engaged in the same line of business for their mutual protection—a willingness to give as well as to receive accurate information as to the manner in which members of the trade handle their accounts. This is accomplished by subscription to the bureau for the service, which in turn is conditional upon the merchant submitting a list of all accounts carried on his ledgers. These accounts are listed by the bureau and a complete list of all accounts submitted by subscribers (revised from time to time) is furnished each member of the bureau, which merely conveys to them the information that the bureau is in a position to supply them with ledger data on any or all of these accounts. When a request for such information is received, the bureau refers to its file, ascertains which members are carrying the account, sends them a blank specifying the information that is desired, and upon its receipt, compiles a report, a copy of which is passed on to the inquirer.

VALUE OF SERVICE. The advantages of this sort of service are numerous, but as we shall soon see, it also has its limitations. First, let us assume that there are 25 wholesale grocery houses in Kansas City, all of them subscribers to the same interchange bureau. Not a single retail grocer in the city could then purchase a bill of goods on credit from one of these houses without any one of the other 24 being able to find out the amount of his purchase and the manner in which he paid his bill. He cannot find out which particular house made the sale, but the report will show the amount of the purchase, when it was made, and when paid for. In this way it can always be ascertained whether a man is prompt or slow in his payments, the amount outstanding, whether he is shifting from one house to another to elude a settlement of his account,

whether he is overbuying or possibly stocking up preparatory to making an assignment. In other words, under the assumed conditions, the service would be ideal.

Next, let us assume that but 5 of these 25 wholesalers subscribe for the service. Of what value is it to know that A's account with none of the 5 is past due, or that his purchases for the past 60 days have not been very heavy? He may owe one of the other 20 houses $1,000 that is 6 months overdue, and have made unusually heavy purchases from still another within the past week.

The point is simply this—the value of the service is dependent upon the extent to which it is participated in by the members engaged in that particular line of business, in the same territory, and as business expands and trading becomes more extensive this sort of service will necessarily become less satisfactory. Theoretically it is ideal, but practically it has its limitations.

Salesmen's Reports

In discussing salesmen's reports as a source of credit information, two questions should be considered:

1. To what extent is one justified, as a matter of good business policy, in asking a salesman to serve as an agent or representative of the credit department?
2. To what extent can the credit information submitted by salesmen be relied upon?

Fancy yourself a salesman employed to sell goods with salary, and possibly a commission, dependent upon the amount of your sales—would you want to be bothered and hampered by having to investigate personally and report on the financial responsibility of your customers? The salesman *must* sell goods, and in most concerns he is not asked to do anything else.

However, a salesman is undoubtedly in a position to render valuable assistance to the credit department by reporting his inferences from personal observation; but it must always be

borne in mind that the principal duty of a salesman is to sell goods and that he is naturally loathe to offend or embarrass a customer, or in any way jeopardize a sale. In justice to him, he should not be asked to supply any information except that obtained from a personal observation of the place of business, his personal opinion of the customer, and such information as can be obtained in a casual way without arousing the customer's suspicion or asking him direct questions.

Prompted by selfish motives, the attitude prevalent among salesmen is: The credit department doesn't help me to sell my goods; why should it call on me for assistance in handling the account? It is only to those who have been educated to the advantages of such co-operation, and to the fact that a salesman should be a company representative rather than a mere order-taker, that the idea is not repugnant.

As for the value of a salesman's reports, it will depend, first, upon his ability to size up a situation and draw correct and reliable conclusions, and, second, upon the extent to which he does not permit himself to become biased by his desire "to sell another bill of goods." In other words, you have to know first your salesman before you can accurately estimate the value of the information he submits concerning an applicant for credit. If he is known to be a keen observer and an unselfish representative of the house, greater dependence can be placed on the information he reports than when the opposite is known to be true.

Bank Reports

Though freely consulted, banks do not constitute a very satisfactory source of credit information; nor is this surprising when it is remembered that this is not one of the purposes for which the bank was established, and that credit inquiries are, as a rule, handled purely as an accommodation, in routine manner, by a force of subordinate clerks.

A bank's first duty is of course to depositors, or bor-

rowers, whose confidence must be respected, and in justice to itself it cannot be of very great assistance to a credit man, simply because of the possibility that confidential information may be abused by a creditor.

Suppose, for example, the merchant or concern being investigated is one of the bank's depositors and the bank also holds some of its paper. The value of the securities would necessarily be affected by a contraction of its credit, so it is hardly reasonable to expect an unfavorable report under such circumstances; whereas the information from another local bank not handling any of the merchant's business and not having had occasion to make a searching investigation of his affairs, is of a very general and non-committal nature. In fact, the number of reports received consisting merely of the bank's favorite and conventional expression, "We believe the man honest and good for his needs," is surprisingly large.

Nevertheless, a large banking acquaintance is an asset to a credit man, for banks can often help him, provided they are so disposed, when the information desired is obtainable through no other source.

Attorney Reports

The attractive feature of attorney reports to credit men is that the information submitted is supposedly based on personal knowledge or personal investigation, but they are generally of little value, because the attorney is not sufficiently well paid to spend the necessary time in getting the information. Many concerns make it a practice to ask for attorney reports only in towns of less than 15,000, where his profession would be more apt to bring him in contact with the business men of his locality and enable him to get the information desired by the credit man with but little time and effort.

In the larger cities many law firms have found this source of business sufficiently profitable to justify the installation of a special commercial department to collect and disseminate credit

data, and by virtue of sufficient handling they soon succeed in amassing a wealth of information of greater value to the credit man than the service of the mercantile agency in that particular locality.

Credit Man's Personal Judgment

It is not to be understood that all of these sources of information are employed in the investigation of every account. That is not only unnecessary, but is also entirely too expensive. In fact, it is only the doubtful accounts that require such a searching investigation, although the credit man likes to know as much as he can about all his accounts, and for this reason reports are frequently asked for even when the concern's credit responsibility is unquestioned. In fact a credit man who conducts a well-regulated credit department will not be satisfied with merely drawing from one or two sources of information, but will "tap every spring from whence he has reason to believe there may flow such information as will be of use to him in deciding the merits of an account." In other words, a complete and accurate file should be the aim of every conscientious credit man.

All reports received through these various channels have at least one thing in common—they present another's view of the situation. But to sense the actual conditions of a business, the evidence of retrogression or development, requires more than second-hand information. Consequently, such reports must be supplemented by the personal judgment of the credit man, based on his experience and knowledge of human nature, and on inferences to be drawn from the resources of the locality in which the customer is located—its population, classes of people represented, and the competition with which the merchant will have to contend. To illustrate, if a crop failure seems imminent in Kansas, it is but natural that he should want to restrict his credit lines in that section and handle his accounts accordingly; on the other hand, if a well-founded oil boom is

under way throughout Oklahoma, he can afford, and is quite justified in assuming greater risks in this section, in view of the increased capital pouring into the state.

A celebrated Frenchman once declared that genius was nothing more than the capacity for taking infinite pains. This certainly is true as applied to the development of genius or efficiency in connection with credit work. And it is simply another way of expressing the thought involved in the truism that "constant vigilance on the part of the credit man is the price of safety."

CHAPTER X

PREPARATION AND ANALYSIS OF FINANCIAL STATEMENTS

Accuracy of Information

In investigating a merchant's character and his business capacity, reliance must necessarily be placed largely upon hearsay reports and the opinions of others, because there is no concrete way of measuring a man's honesty or ability. But in the investigation of a merchant's financial strength, or the capital factor, this element of his credit responsibility can be figured out with mathematical precision.

Order of Discussion

When considering subjects of a strictly technical nature, the readiness and ease with which the fundamental principles are grasped and comprehended by the reader depend in large measure upon the sequence in which the different aspects of the subject are presented and discussed. And with this fact in mind special care and effort have been taken in this and the next several chapters to deal with the subject of financial statements in a way which will prove most helpful and easy of comprehension.

The following outline will be observed:

1. The preparation of financial statements.
2. The theory of the analysis of financial statements.
3. Application of the theory to simple statements, corporate statements—balance sheets and profit and loss statements—and comparative statements.
4. Importance of working capital in a business.

Form of Statement

A financial, or property, statement is nothing more than a report or statement of the financial condition of a business or commercial organization at a given time, by setting forth in some classified manner the assets and liabilities. When submitted as a basis of credit it should also conclude with a signed statement to the effect that:

> The above statement made ror the purpose of establishing credit is a full and correct statement of our financial affairs as of the ...... day of ...., 19—.
>
> Signed:
>
> ....

The statement may be general or detailed in the manner in which the information is presented. It may be condensed or consolidated. But irrespective of these differences as to its compilation, it remains a financial statement. The information is there, whether the assets and liabilities are presented side by side, or one group above the other. And the information contained should be the same no matter by which name the statement is known—property statement, balance sheet, or financial statement. The difference is essentially a technical one, depending on whether the information is presented in the account or the report form.

Parties Interested

One general principle that can be laid down as governing the compilation of financial statements is that each statement must be complete as to content and arranged comprehensively if it is to be of any practical value or use. By this is meant that whatever plan of grouping is followed, the order on the liability side of the balance sheet should correspond with the order on the asset side; i.e., current liabilities should appear opposite current assets, and the fixed liabilities opposite the fixed assets.

In considering this point it may be well, first, to look for a

moment at the parties in interest in such statements. These are, first, those who contribute the capital, or finance the organization, second, those who manage the organization, and third, those who develop relations with the organization as debtors and creditors. Each of these is interested in knowing that his funds have been not only advantageously employed but that they are secure, and financial statements offer the means of satisfying the desire for such information.

To the manager of the business, financial statements furnish him with excellent facilities for getting in touch with the general divisions of his organization which size and other conditions prevent him from coming in personal contact with and which thus transcend the limits of his personal observation.

The creditors are equally interested parties. Before merchants or banks will extend credit or make loans, they insist on knowing that the concern seeking the accommodation is in good financial standing and what its prospective earning power is. Both these facts may be disclosed by properly prepared financial statements. In other words, financial statements which convey the proper information to the administrative officers or proprietor of a business are very likely to prove entirely satisfactory to any other party or parties at interest.

Arrangement of Items

A classified balance sheet appears to meet the requirements of all interested parties. By "classified" balance sheet is meant one in which the assets and liabilities are classified in accordance with their function in the business. Thus assets may be classified as capital assets, current assets, fixed assets, miscellaneous, and deferred. In classifying liabilities very much the same order may be followed. Such a classification would give to any interested party information concerning the assets and liabilities. It would also enable anyone to compare any group of liabilities with any corresponding group of assets. Of course, in the case of a sole proprietorship or the ordinary

partnership, such statements will, as a rule, partake of a more simple form than those of an extensive corporate enterprise.

As to the general arrangement, quite a difference of opinion and a wealth of discussion may be found. There are those who contend that the current assets should be shown first, arranged in the order in which they will be realized upon; and that the current liabilities should appear at the head of the statement on the other side, arranged in the order in which they will be liquidated. Others contend that capital assets and liabilities respectively should head the statement. Fundamentally the basis for this difference of opinion seems to be that those who argue for preference for the current assets and liabilities seem to have principally in mind the interest of creditors; whereas those who contend that the capital assets and liabilities should be given preference seem to look at the situation from the standpoint of the proprietor or stockholder.

In either case, however, the current assets should be arranged in the order in which they will ordinarily be realized upon, namely, cash, accounts receivable, notes receivable, and merchandise. In the case of a going concern, goods not sold for cash are sold on account; and when a customer finds himself unable to pay the account within the time stipulated in the terms of sale, he as a rule asks for an extension of time and tenders his note.

The same principle of arrangement may be said to apply to the current liabilities. They should be listed according to the natural sequence in which they will be liquidated—owing for merchandise, accounts payable, notes payable, and the other current liabilities following in proper sequence.

Whether investments, or securities owned, shall be classed as fixed or current assets is a debatable point and largely depends upon the purpose for which they are held. For example, it is not probable that anyone would think of considering shares of stock of a subsidiary concern held for purposes of control as a current asset. On the other hand, scarcely any-

thing is more marketable or more readily and easily convertible into cash than certain classes of securities, e.g., Liberty bonds. Consequently, a proper test as to whether such investments or securities shall be classified as fixed or current assets would seem to be this: If such securities are held for purposes of control or as a permanent investment of excess capital until the time when the usual current assets will not be realized upon fast enough, they should be considered fixed assets; whereas if they are readily convertible into cash and are being held for the purpose of liquidating existing current liabilities, they should be considered as current assets.

The items of good-will, copyrights, patents, etc., frequently come up for discussion, and the question of whether they should be included among the capital assets will be discussed later (see page 152).

Statement Form Illustrated

The general arrangement of the financial or property statement of a sole proprietor or a partnership is as follows:

Assets		*Liabilities*	
Cash:		Accounts Payable.........	$......
On Hand..............	$......	Notes Payable............	......
In Bank...............	......	Owing for Merchandise....	......
Accounts Receivable.......	......	Mortgages:	
Notes Receivable..........	......	Chattel...............	......
Merchandise.............	......	Real..................	......
Fixtures.................	......	Net Worth...............	......
Realty..................	......		
Total................	$......	Total................	$......

Form 5. Balance Sheet of a Sole Proprietorship or a Partnership

Such a statement should also be supplemented with certain essential operating facts, the most important of which is the volume of sales, in order that the inventoried condition of the merchant may be ascertained. For some reason or other it is often quite difficult to secure such information and the objec-

tion is frequently raised that it is of too confidential a nature to risk the chance of it becoming known to a competitor. Disclosure should also be made as to the presence of any contingent liabilities, such as hypothecated receivables, accommodation indorsements, etc.

Forms of Financial Statements

Almost all of the larger houses have their own special form of property statement, drawn up in accordance with their own ideas, and while they differ in form and arrangement, they are in effect the same, being compiled with a view to obtaining the same information in regard to a credit-seeker's business affairs. The standard form (Form 6) drafted and adopted by the National Credit Men's Association for an individual or partnership will serve as a splendid example.

The Theory of Statement Analysis

It is an oft-quoted axiom that "figures don't lie," but for our purpose it might be well to add, "but credit men know better," and a day's experience at a credit desk suffices to justify and to corroborate this somewhat contradictory modification.

Financial statements when complete and carefully prepared, and when skilfully analyzed, supply one of the most satisfactory sources of information on which to base an extension of credit. Information and facts can be obtained which are not available to the credit man from any other source. And while the data are different in both arrangement and amounts in each and every statement submitted, the process of analysis remains the same and is applicable to all alike. Therefore, once the theory is understood, all that remains is to be able to apply it, which is largely a matter of training and experience. As for the importance of this ability, a remark frequently quoted is significant: "Here is where the credit man earns his salary."

"Large assets are not always necessary to the creation of credit; what is most desirable is, that credit be in relative proportion to the actual assets."

PROPERTY STATEMENT

TO

"The giver of credit is a contributor of capital, and becomes, in a certain sense, a partner of the debtor, and, as such, has a natural right to complete information of the debtor's condition at all times."

Form Adopted and Recommended by the National Association of Credit Men

For the purpose of obtaining merchandise from you on credit, we (I) make the following statement in writing, intending that you should rely thereon respecting our (my) financial condition as of (Date) .... 19......

(All questions should be answered. When no figures are inserted, write word "None.")

ASSETS			LIABILITIES		
Cash in hand........................	....	....	For MERCHANDISE:		
Cash in bank........................	....	....	Accounts owing not due..........	....	....
Accounts owing by customers, good and collectible, not pledged or sold..	....	....	Accounts owing past due..........	....	....
Notes owing by customers, good and collectible, not pledged or sold......	....	....	Trade Acceptances payable.......	....	....
Trade Acceptances receivable, not pledged or sold..................	....	....	Notes payable for Mdse..........	....	....
Merchandise: (not on consignment or conditional sale.) (How valued; Cost...... Market......).......	....	....	For BORROWED MONEY:		
Other quick assets (Describe)......................	....	....	Notes payable to banks...........	....	....
....	....	....	Notes or debts payable to others (including relatives and friends)..	....	....
....	....	....	Deposits of money with us. (Describe)..........	....	....
			Owing for Wages and Salaries.......	....	....
			Owing for Taxes (city, state and federal)........	....	....
			Owing for Rental................	....	....
			Owing for Insurance Premiums......	....	....
TOTAL QUICK ASSETS	....	....	TOTAL QUICK LIABILITIES	....	....
....	....	....	....	....	....
Machinery. (How valued; Cost.... Depreciated....)...............	....	....	Debt secured by mortgage on land or buildings..........	....	....
Fixtures and other Equipment. (How valued; Cost.... Depreciated....).	....	....	Debt secured by chattel mortgage or other liens..........	....	....
Land and Buildings as described below.	....	....	Debt secured by judgment..........	....	....
....	....	....	Other liabilities: (Describe)..................	....	....
Notes and Accounts owing from officers, employees, or others not customers.........................	....	....	....	....	....
Other assets: (Describe)......................	....	....	....	....	....
....	....	....	....	....	....
....	....	....	TOTAL LIABILITIES	....	....
			NET WORTH..................	....	....
TOTAL ASSETS	....	....	TOTAL	....	....

What books of account do you keep?..

Was this statement made from those books?................ Do you keep cost records?...............

Do you sell or pledge your accounts to creditors, banks, finance companies or others?........... If so, what amount is so sold or pledged? $.......... What amount of your accounts have you sold or pledged during the past twelve months? $..........

Are any creditors secured by mortgage or lien of any sort?............ If so, how?...................

....

Are any claims in attorneys' hands or suits against you?...

Have you merchandise on consignment or conditional sale?............ If so, what amount? $.........

If business property is leased, for what term and what rental?..

Name and locality of your bank or banks..

Location and kind of business..

Previous business experience............................ Where.........................

It is important that every question on both sides of this sheet be correctly answered and that the blanks be carefully filled in. In answering questions involving amounts write the word "none" where figures do not apply. You will find it advantageous to keep a copy of this statement for comparison with the showing you will be able to make a year hence.

Form 6. Standard Form of Balance Sheet Adopted by the National

INSURANCE

On Merchandise $.......... On Buildings $.......... Machinery $.......... Fixtures $..........
Other Equipment $.............................. Employers' liability $..........................
Is any insurance assigned?........ What amount?........ To whom?..............................
Amount of life insurance for benefit of business $..
With what companies...

SUMMARY OF PROFIT AND LOSS

Inventory of Mdse. beginning of fiscal year (not including fixtures or equipment)........	....	...	Sales last fiscal year..................	....	...
Cost of Mdse. purchased during the year.	....	...	Income from all other sources........	....	...
General expenses including salaries, losses, etc........................	....	...	Inventory of Mdse. at close of year....	....	...
			Total Income for year................	....	...
			Less Total Expenses..................	....	...
TOTAL EXPENSES....	....	...	NET PROFIT FOR YEAR....	....	...

RECORD OF LAND AND BUILDINGS

Title in name of	Description and location	Book value	Assessed value	Amount of Encumbrances	To whom
....	....	....	....	....	....
....	....	....	....	....	....
....	....	....	....	....	....
....	....	....	....	....	....

BUY PRINCIPALLY FROM THE FOLLOWING CONCERNS

Names	Addresses	Amount Owing			
		Open Account		Notes	
....	....	....	....	....	....
....	....	....	....	....	....
....	....	....	....	....	....
....	....	....	....	....	....

Names and Addresses of Owners of Business...
....
....

REMARKS:

The foregoing statement has been carefully read (both printed and written matter) and is in all respects complete, accurate and truthful. It discloses to you the true state of our (my) financial condition on the date above stated. Since that time there has been no material unfavorable change in our (my) financial condition; and if any such change takes place we (I) will give you notice. Until such notice is given, you are to regard this as a con tinu.ng statement.

Firm Name..
Signed by..
Street..................Town................State..........

Date of signing statement....................19....

Form R.

Credit Men's Association for Sole Proprietorship or Partnership

Comparison of Assets and Liabilities

To begin with, we must know just what information we wish to obtain from a property statement. We want to determine the true financial condition of the business. This we do by ascertaining the existing relation between the assets and liabilities, that is, by making a comparison between what it owns with what it owes—by striking its "credit balance," so to speak.

Assuming the total assets to be larger than the total liabilities, the difference represents what is known as the "net worth" or capital of the business—the proprietorship. A seemingly natural and logical inference is that the larger the net worth, the larger the line of credit to which the business is entitled. But this is "jumping at conclusions," and it does not necessarily follow, as we shall soon see.

From a credit point of view solely, a concern is in a healthy financial condition only when it has on hand or subject to immediate command at least sufficient cash to pay its debts as they fall due. So, a credit man is interested in finding out:

1. The prospect of the buyer being able to pay the credit man's bills as they fall due.
2. The likelihood of forcing a settlement of the account in event it becomes necessary.

Classes of Assets and Liabilities

A word of explanation is necessary at this point. It has to do with the distinction that is made between the quick, or current, assets, and the fixed assets; and also with the corresponding distinction between the quick, or current, liabilities and the fixed liabilities. In other words, we have two distinct kinds of assets and two distinct kinds of liabilities to deal with.

The assets that are being converted into cash from day to day and which in turn are used and depended upon to pay the current expenses of the business are termed "quick," or current assets. Such are the merchandise, accounts and notes receiv-

able, cash, etc. The other assets, although they represent actual value and money permanently invested in the business, cannot be used in payment of the current expenses incidental to operating the business, and are therefore termed "fixed" assets. Such are the fixtures, furniture, machinery, tools, other plant equipment, and real estate.

An analogous distinction is also made in the liabilities between what constitutes the quick or current liabilities and what constitutes the fixed liabilities—the former consisting of those obligations which will mature or fall due in the immediate future, such as bills owing for merchandise, and accounts and notes payable, and the latter consisting of the obligations which do not mature for some considerable time and are subject to delayed payment, such as real and chattel mortgages.

Prospect of a Buyer Paying His Debts When Due

Speaking generally, whether a merchant will be able to pay his debts as they fall due will depend upon the amount of money he has on hand after paying his existing current obligations. How is the creditor to ascertain how much that will amount to? By ascertaining the difference between the amount of money to be received from the current assets and the amount which is to be paid out in settlement of the current obligations. The excess of the former over the latter (when such exists) is called the "working capital" of the business. In other words, the difference between the current assets and the current liabilities constitutes the fund the merchant will have with which to pay your account.

This is simply another way of saying that by "credit capacity" of the business we mean the power to discharge obligations as they fall due. This power depends not upon the amount of the capital in the business, but rather upon the form in which it is distributed among the assets. To express the same thought in still another way, it is the availability of the assets that measures the credit capacity of the business.

So long as there are current or quick assets present in excess of current or quick liabilities, creditors have no immediate cause for anxiety. But reverse the situation and there is danger ahead, for under such circumstances it is obvious that creditors will have to wait for their money because the merchant can no longer pay his bills as they fall due.

It is therefore clear that the prospects of a business paying its bills promptly at maturity depends primarily upon the amount of its working capital.

Determining the Line of Credit

Assuming the amount of working capital available in the business has been ascertained, the next question that presents itself is: In what amount shall credit be extended?

1. For the full amount? Let us suppose that the working capital of a business amounts to $5,000, and you extend credit for that amount; also that five other concerns which are selling it merchandise do likewise. Then, in event of a forced liquidation, how much would you and the other five creditors receive on your accounts?

2. If not for the full amount, in what proportion? As a general rule, it should be gauged and measured by the relative proportion that your goods will bear to the entire business. If the working capital is $30,000, inasmuch as your goods will constitute one-fifth of the entire stock of merchandise, the credit line extended by you should be $6,000.

This is simply an arbitrary rule, which is theoretically well founded but not strictly observed or adhered to in practice. If it were, it would serve to guard against and in large measure prevent overstocking, which is the usual forerunner of insolvency.

There are several reasons why this principle is not strictly observed and applied in practice: (1) The human element is ever present, and it is a natural characteristic of human nature "to take a chance" in some degree; and (2) it is oftentimes

quite difficult even to approximate the ratio that your goods will constitute to the entire stock of the merchant, although the accuracy with which this can be done by a credit man of long experience in a particular line of business is surprising.

Likelihood of Forcing Payment

In calculating the prospects for collecting the full amount of the account in event it becomes necessary to force a settlement by means of legal process, the fixed assets and fixed liabilities must also be taken into consideration, because as a last resort the fixed assets may be subjected to sale, and after the liens or obligations outstanding against them, such as chattel mortgages, etc., have been satisfied, the proceeds may be applied in payment of the account. In other words, the second object of the credit man in analyzing a financial statement is accomplished by ascertaining whether there is a sufficient equity in the fixed assets to serve as a satisfactory and adequate protection, or insurance, against suffering an ultimate loss on the account. For this purpose the net worth or excess of total assets over total liabilities is not infrequently used.

A situation is frequently encountered where the statement shows an appreciable net worth, but on analysis, no working capital; or, where the total assets are considerably in excess of the total liabilities, but where the quick liabilities are in excess of the quick assets. This situation represents what is meant by a "floating debt." To extend credit to a concern in such a condition is almost equivalent to buying a lawsuit (the expense of which is not included in your selling price) inasmuch as it is obvious from the finances of the business that the current obligations cannot be met as they fall due.

Statement Analysis Illustrated

Before proceeding further let us examine two simple statements by applying the process we have just been considering. The first statement is as follows:

CAMPASS AND COMPANY
Wholesale and Retail Grocers

Assets		*Liabilities*	
Cash:		Owing for Merchandise	$ 9,500.00
In Bank	$ 2,000.00	Accounts Payable	1,500.00
On Hand	900.00	Notes Payable	6,000.00
Accounts Receivable	8,000.00	Mortgage on Fixtures	3,000.00
Notes Receivable	2,100.00	Mortgage on Realty	10,000.00
Merchandise	17,000.00	Net Worth	26,500.00
Liberty Bonds	1,500.00		
Fixtures	10,000.00		
Realty	15,000.00		
	$56,500.00		$56,500.00

Let us assume that you or your company is engaged in the manufacture of lard compound, which constitutes only one of the ten different products carried by the average wholesale and retail grocer. Classifying and separating the quick assets and quick liabilities in order to ascertain the working capital, we find the following:

Quick Assets		*Quick Liabilities*	
Cash in Bank	$ 2,000.00	Owing for Merchandise	$ 9,500.00
Cash on Hand	900.00	Accounts Payable	1,500.00
Accounts Receivable	8,000.00	Notes Payable	6,000.00
Notes Receivable	2,100.00		
Merchandise	17,000.00		$17,000.00
Liberty Bonds	1,500.00		
	$31,500.00		

A working capital of $14,500 is thus disclosed. The fixed assets and fixed liabilities are as follows:

Fixed Assets		*Fixed Liabilities*	
Fixtures	$10,000.00	Mortgage on Fixtures	$ 3,000.00
Realty	15,000.00	Mortgage on Realty	10,000.00
	$25,000.00		$13,000.00

This discloses an equity in fixed assets of $12,000.

Proceeding on the assumption that your company's goods

will constitute approximately one-tenth of the firm's entire stock of merchandise, theoretically its financial status would justify his extending credit up to $1,450, or a credit line of $1,500.

The second illustrative statement is as follows:

M. Deyer and Company
Manufacturers of Misses and Children's Dresses

Assets		*Liabilities*	
Cash in Bank	$ 1,018.87	Accounts Payable	$15,044.06
Cash on Hand	125.19	Notes Payable	8,100.00
Accounts Receivable	12,000.00	Mortgage on Realty	5,000.00
Merchandise	10,000.00	Net Worth	40,000.00
Furniture, Fixtures and Machinery	30,000.00		
Realty	15,000.00		
	$68,144.06		$68,144.06

We will assume that your company is engaged in the manufacture of dress trimmings, and that the average cost of the trimmings on a $25 dress amounts to $5, or 20 per cent of the cost of the materials used.

Classifying and segregating the quick and fixed assets, and likewise the quick and fixed liabilities, we find:

Quick Assets		*Quick Liabilities*	
Cash in Bank	$ 1,018.87	Accounts Payable	$15,044.06
Cash on Hand	125.19	Notes Payable	8,100.00
Accounts Receivable	12,000.00		
Merchandise	10,000.00		
	$23,144.06		$23,144.06

Fixed Assets		*Fixed Liabilities*	
Furniture, Fixtures and Machinery	$30,000.00	Mortgage on Realty	$5,000.00
Realty	15,000.00		
	$45,000.00		

In this case the analysis discloses that while there is a net worth of some $40,000 in the business, there is absolutely no working capital available. This signifies that after the existing current indebtedness is paid, no available current assets remain with which to satisfy your account in event credit was extended, and hence the company constitutes an undesirable present risk in every sense of the word.

Other Theories

There was a time when it was the policy of banks to insist upon an existing ratio of 2 to 1 between the quick assets and the quick liabilities as the accepted measure of financial soundness, before they would extend credit to a merchant. But it is more or less doubtful if that rule was ever strictly applied. In any event it is not strictly adhered to in their present-day practice. This rule has, however, been accepted and is still applied in practice by many credit analysts.

Owing to the diversity of opinion that exists on the subject, it is interesting to note the views of several credit men of standing, and also a summary of the report made by the president of a large commercial bank after conducting a similar investigation. One well-known credit man commits himself to this extent:

> I usually look for a 2 : 1 ratio in analyzing a financial statement. However, I am willing to grant a line of credit even if this ratio is 1 : 1, providing the merchant has proven business ability and is morally O.K.

In contrast, this opinion is expressed by another:

> I do not believe that there is any fixed ratio that is helpful in measuring credit. Credit is not, and never can be, measured by a carpenter's rule.

Following is a summary of the bank president's view:

> Common practice has (as far as has been made public) developed only one general theory of extending commercial credit which has become accepted as more or less standard. This

theory is known as the two-for-one rule, and consists of the principle that in order to establish a good credit proportion, the statement must show at least two dollars of current assets for every dollar of current liability. The reason for this measure is basically sound, because from a credit standpoint companies must be looked at, partially at least, as a liquidating proposition, in which there is bound to be a shrinkage of assets, in that some accounts will be slow and bad, and some merchandise out of season and antiquated, whereas the corresponding debt is not subject to shrinkage. These proportions have become accepted only by common practice, and there is a question as to whether the two-for-one, or the 200% ratio, is right, too large, or too little. It provides a substantial margin, and has on that account become rather generally acknowledged as safe. The establishment of any such ratio is not a matter of theory, but has been a matter of experimentation. The adoption of the current ratio theory is in itself purely a quantitative proposition, in which the current assets in bulk are measured against the current liabilities in bulk. It is quite as important, however, that a qualitative analysis of the current assets be made, and for that reason other ratios have been developed. . .

In discussing this subject Mr. Koelsch, former president of the National Association of Credit Men, has said:

> The ratio of 2 or 3 to 1 was a rough sort of working rule in the period from 1897–1916 when prices did not vary enough or so quickly as to cause much trouble. The proportion of the assets to the current liabilities depends for its importance upon the character of the assets, and it does not pay a proprietor to deceive himself upon this point even if he can make the proportion satisfactory to creditors.

This current ratio of 2 to 1 simply means that a debtor should have $2 of current assets for every $1 of current liabilities. This margin of current assets has always been demanded because of the moral certainty that the current assets will not, in liquidation, produce a full 100 cents on the dollar as entered upon the statement. The shrinkage in the value of the current assets, however, is not accompanied by an offsetting shrinkage in liabilities.

"Acid Test"

Still another way of testing the strength of a financial risk consists in applying what is commonly known as "the acid test," whereby the total of the cash and the accounts and notes receivable (the merchandise and other current asset items are disregarded) is measured against, and is supposed to equal in amount, the total of the current liabilities.

This test is even more conservative than the 2 to 1 standard, and there are, of course, many risks that should be considered good in spite of their inability to satisfy any such requirement.

CHAPTER XI

DESCRIPTION AND VALUATION OF ASSETS AND LIABILITIES

Listed and Actual Valuations

In actual practice there is still another phase of statement analysis to be considered which has to do with the determination of the actual as distinguished from the listed valuation of the assets, for it can be safely assumed that the applicant for credit, in an endeavor to make a good showing, has listed his assets at their highest value and estimated his liabilities as conservatively as possible, rendering it obviously imprudent to accept the figures at their face value. It is thus necessary for the credit man to "shade the assets," or to write off a certain percentage merely as a precautionary measure. The important factor is not the applicant's opinion as to the value of his assets, which the listed valuation altogether too frequently represents, but the actual value that will ultimately be realized from them. The liabilities, as a rule, present no such difficulty, for what a merchant owes is a question of fact, e.g., if he owes you $200, his opinion as to whether it is more or less than $200 will not change the fact that the actual amount owing is $200.

No fixed rule or principle can be laid down as governing this phase of the procedure, and the percentage that should be written off in estimating the working capital and the true net worth will vary in accordance with the different lines of business and the individual judgment of the credit man, as based upon his personal experience in the business.

As a condition precedent, however, to the determination of the extent to which the various asset items should be written

off, it is necessary for the credit man to understand the nature of the assets he is dealing with—their susceptibility to inflation.

Merchandise

This item includes raw materials, goods in process of production, and finished goods which are to be sold in the ordinary course of trade. In appraising the worth of this asset consideration must first be given to the method employed by the maker of the statement in taking inventory, for various methods may be employed in valuing the merchandise. Was the inventory taken at cost, the prevailing market price, or the sale price? The more conservative practice is to use the lowest of the three, and this basis is considered preferable on the theory that the value of an asset, or its debt-paying power, is determined entirely by the amount of money that will be received for it at the time of its disposal, and that even though the cost of the goods be greater than the current market price, it is the prevailing market price which will determine their ultimate worth.

Allowance must also be made for old stock and depreciation, for it must be remembered that while in the ordinary course of business, merchandise is sold at a profit, the stock is subject to physical deterioration, changes in style and fashions, errors in buying, or decline in value. Furthermore, time, effort, and expense are required to convert it into cash, which necessitates an additional allowance for a percentage of the overhead expense. The larger the proportion of the merchandise in the shape of raw material, the greater is the prospect of realizing full value on the goods in the case of a forced sale, because as such it is not subject to changes in style, and is more readily convertible into cash.

There is no uniform basis or scale for writing off the merchandise item. The percentage varies according to the value of the commodity represented within general limitations, and for several lines of goods is as follows:

General Merchandise	20% –	30%
Groceries	10 –	20
Dry Goods	20 –	25
Hardware	25 –	30
Millinery	35 –	60
Clothing	25 –	35

Accounts Receivable

Accounts receivable are simply book accounts, sometimes called "open" accounts, with the customers of the concern. Next to cash, accounts receivable represent the most live asset in the business of a merchant or manufacturer. The item should include only unpaid charges against solvent debtors which are reasonably certain to be paid at maturity, or within a reasonable time thereafter. That is to say, accounts receivable should include only those open accounts for goods sold and delivered which can be relied upon for the payment of creditors' claims.

Frequently, however, in an endeavor to bolster up this item, bookkeeping balances and even loss accounts which are not to be collected in the usual course of business and which have no debt-paying power whatsoever, are included, and it is to provide for this ever-present contingency that allowance must be made in estimating the worth of this item.

Assuming, however, that only balances due from solvent customers are included, a normal allowance must still be made for bad debts, the percentage of which varies in different lines of business anywhere from 1 to 10 per cent. Where no distinction is made in listing the accounts receivable between accounts good and collectible, and accounts overdue, the extent to which they should be written off varies from 25 to 50 per cent.

Notes Receivable

This item should include only negotiable promissory notes received from customers in payment for goods sold and de-

livered. It should not include notes, or IOU's from members of the firm, officers, directors, subsidiary or allied companies, or any other similar obligations. Nor should notes which have been discounted, assigned, or transferred be included.

In most lines of business, debts for goods sold and delivered are usually evidenced only by open book accounts, and where this system prevails the closing of an account by note indicates, as a rule, a past-due account on which an extension has been granted. In some lines of business, however, it is customary for concerns to close their open book accounts with trade acceptances, and where this system prevails the notes receivable should be valued in the same way as the accounts receivable in other industries. In fact, a higher valuation might be placed on the trade acceptances, for they should prove easier to collect than the open accounts receivable.

Cash

This item should represent the amount of cash on hand and in bank subject to immediate withdrawal. It should be remembered that in event the merchant is indebted to the bank in which his funds are deposited, the bank has a lien against the deposit for the amount of the loan.

If free from encumbrance and correctly stated, the cash item may be accepted at its face value in estimating its debt-paying power. It is always advisable, however, to have the cash on hand and the cash in bank set forth as separate items, and in event the cash on hand is unusually large in amount, the inference may reasonably be drawn that it probably includes some IOU's or unexpended salesmen's balances.

Investments

The credit man is often called upon to appraise the worth of various forms of outside investments, such as stocks or bonds of subsidiary companies, or securities in other com-

panies. If the securities are readily salable, such as Liberty bonds or stocks listed on the New York Stock Exchange, they are quick assets and their value for debt-paying purposes is readily ascertainable. On the other hand, if the securities are stocks or bonds of subsidiary companies and held merely for purposes of control, they are fixed assets and not available for paying debts incurred in the ordinary course of business. If the item represents securities in other and unknown companies, they are, as a rule, disregarded entirely by the credit man in estimating the merchant's credit capacity.

Deferred Assets

This item includes charges which have been paid in advance and which are properly applicable to a subsequent period, such as taxes and unexpired insurance premiums. Beyond signifying that the merchant employs a comprehensive system of accounting, such assets, not having any debt-paying power, should be practically disregarded in analyzing financial statements.

Plant, Machinery, and Tools

In estimating the worth of such properties a sufficient allowance must be made to cover depreciation due to wear and tear, and obsolescence due to competition of other improved machinery and equipment. This is generally offset by a special reserve created for the purpose and carried as a liability.

Such fixed assets are not to be sold in the usual course of business and consequently are not available to meet current business obligations. On the other hand, their presence does add to the stability of a business, and in event of a forced liquidation they could be sold and the proceeds applied in payment of creditors' claims, although the amount realized would probably not amount to more than 50 per cent of their listed value.

Furniture and Fixtures

As in the case of the other fixed assets, adequate allowance should be made for depreciation, and in estimating the worth of this item in event of a forced liquidation, their listed value should also be written off approximately 50 per cent.

Intangible Assets

Intangible assets, such as patterns, good-will, unissued stock, copyrights, patents, and assets of like character, should be practically disregarded in analyzing financial statements. To a going concern they are not resources available for debt-paying, and to an insolvent concern they are usually worthless.

Insurance

The question of fire insurance is a very important one in considering a credit risk and a credit man should always require information as to the amount of fire insurance carried, because in event no fire insurance is carried by the applicant for credit, a fire may destroy his entire stock and leave little for the payment of creditors. In other words, the merchant who does not carry adequate fire insurance is a dangerous risk. In event the amount of insurance carried is considerably less than the estimated value of the tangible assets, it justifiably leads to suspicion that the value of the assets has been overstated.

Life insurance on the lives of officers of a corporation, or the members of a firm, or the life of a sole proprietor, is frequently carried as a business investment and also as a further protection to creditors from some possible disaster which might seriously embarrass or possibly bankrupt a well-established business. In such cases the carrying of business life insurance tends to strengthen the credit risk by decreasing the potential risk of ultimate loss.

Liabilities—Owing for Merchandise

Turning now to the liabilities, the item, "owing for merchandise," should always be shown as a separate and distinct liability. It should also be subdivided so as to show: (1) the amount not due, and (2) the amount past due. The reason for this is that the amount is not very apt to be understated when separately shown, for it is easily verified by creditors, especially in the case of the insolvency of the debtor, whereas if the amount owing for merchandise was included with other business obligations under the one item of accounts payable, the item would be more susceptible to falsification and the detection of overstocking, the usual forerunner of bankruptcy, would be more difficult.

Accounts Payable

This should represent the total amount owing to creditors on open account, excluding, of course, the amount owed for merchandise when the latter is shown as a separate liability. A division of this item also should be made to show: (1) the amount not due, and (2) the amount past due.

Notes Payable

This item may include notes payable: (1) to banks, (2) to merchandise creditors, or (3) to others, meaning members of the firm, officers of the corporation, or relatives or friends of the individual merchant.

If the amount owed to banks is large, it may represent loans negotiated for the purpose of discounting bills of purchase—an entirely legitimate and common practice. If the statement shows a large amount of notes payable to merchandise creditors, it as a rule represents trade acceptances outstanding which were given for supplies purchased. In such a case the "owing for merchandise" item should show a correspondingly low balance. The presence in the financial statement of a large amount of "notes payable to others" is usually

regarded as a signal for the exercise of caution on the part of the credit man, because when a merchant finds it necessary to borrow from his friends and relatives, it indicates that his banking credit has probably been exhausted. Furthermore, in event of insolvency it would be but a natural tendency for a merchant to place the interests of his friends and relatives above those of his general creditors.

Reserves

These usually represent the estimated depreciation of one or more of the assets, some accrued liability, or part of the surplus set aside for some particular purpose. In the latter case the title by which the reserve is designated would usually indicate its purpose.

Mortgages

The due date of a mortgage is of great importance to a credit man because it frequently happens that where property has greatly depreciated in value the mortgage may not be renewed and thus an apparent asset represented by the book equity of the investment may be entirely wiped out by foreclosure proceedings, or possibly converted into a liability in event the property is sold for less than the amount of the mortgage.

Practical Application of Analysis Theory

Once the merchant's working capital has been established with assets properly "shaded," credit is extended accordingly, provided there is a sufficient equity in the fixed assets to serve as a protection against any ultimate loss. We may examine several simple statements in the light of the preceding discussion.

The following statement, we will assume, is submitted by a wholesale grocery concern that is seeking from us a line of credit of from $2,500 to $3,000:

Assets

Merchandise on Hand		$46,641.00
Accounts Receivable		5,250.00
Cash on Hand and in Bank		1,410.00
Furniture and Fixtures		4,800.00
Store		8,450.00
Total Assets		$66,551.00

Liabilities

Owing for Merchandise	$9,500.00	
Loans from Bank	2,400.00	
Total Liabilities		11,900.00
Net Worth		$54,651.00

Assuming it customary to "shade" the merchandise of wholesale grocers one-fourth and the receivables from one-half to three-fourths of their estimated value, the wholesaler's working capital amounts to approximately $25,803, found by subtracting from merchandise of $34,981, receivables of $1,312, and cash (as stated) of $1,410, the liabilities (as stated) of $11,900.

This case then presents no great difficulties, for assuming our goods will constitute one-tenth of his entire stock, a credit line of 10 per cent of $25,803, or approximately $2,500, would be justified, particularly in view of the fact that fixed assets are present in sufficient amount to afford the necessary protection.

The following statement is submitted by another wholesale grocery house, and it will require a line of credit of $100 to carry the account:

Assets

Merchandise	$2,700.00
Accounts Receivable	3,000.00
Cash on Hand and in Bank	810.00
Furniture and Fixtures	500.00
Equity in Residence	1,000.00
Total Assets	$8,010.00

Liabilities

For Merchandise, Not Due........	$2,300.00	
For Merchandise, Past Due.......	700.00	
Notes Payable....................	500.00	
Total Liabilities.........................		3,500.00
Net Worth............................		$4,510.00

By writing off the merchandise and receivables in the same manner as before, we find his available working capital amounts to merchandise of $2,025, receivables of $750, and cash of $810, amounting in all to $3,585, less the quick liabilities of $3,500, or to $85. The fixed assets are valued at $1,500.

Here is a case typical of the kind credit men often have to pass on, and upon which some are willing to take a chance. A large share of the merchant's capital is represented by book accounts, showing that he either extends credit too freely or has included a large number of past-due accounts in his statement—just what portion of his outstandings are considered good and collectible, we are not informed.

His merchandise indebtedness is larger than his stock on hand, from which it is quite evident that he is overtrading; and while it is not impossible, or, for that matter, improbable, that he may continue indefinitely in this uncertain and unstable condition, he is in no shape to "weather a storm," and the element of uncertainty is too great to justify assumption of the risk. In other words, we are better off with the account off our books than we would be with our goods on his shelf.

Collateral or Derivative Information

These examples illustrate the simple and almost mechanical phases of statement analysis, whereas, in doubtful cases especially, the credit man should continue his investigation by making such other comparisons as afford an insight into the manner in which the business is being conducted. A number of these are as follows:

1. Business profits are directly dependent upon two factors: (a) the margin of profit realized on sales; (b) the number of times that profit is made, which is the business turnover. In other words, by "turnover" we mean the number of times a year a merchant is able to convert his stock of merchandise into cash. The ability to "turn" merchandise into cash quickly indicates good management; for, assuming the margin of profit to be the same, the merchant who can turn his stock over, say four times a year, realizes more on his capital investment than a competitor who is able to turn his stock but three times.

Given the merchandise on hand and the annual sales, we can calculate the approximate number of times a merchant is turning over his stock by dividing the merchandise on hand into the annual sales, as shown below:

$$\frac{\text{Annual sales (\$30,000)}}{\text{Merchandise on hand (\$5,000)}} = \text{Annual turnover (6 times)}$$

While this is the usual method adopted by credit men in figuring the approximate turnover, it is neither correct nor accurate from a strictly technical standpoint, due to the fact that the turnover has been figured on the volume of sales, which includes profits, whereas the merchandise is based on cost.

The turnover may be figured accurately according to either of two methods: (1) by dividing the cost of inventory into the cost of sales; (2) by dividing the total sales by the value of the merchandise at the sales price. If, for the purpose of illustration, we assume that in the case above mentioned the merchant has realized a net profit of 25 per cent, we find that he has actually turned his stock but four and one-half times:

1. Based on Cost

Value of merchandise inventoried at cost......	$ 5,000
Cost of sales ($30,000 less 25% profit)......	22,500
Turnover..................................	4½ times

2. Based on Sales Price

Sales price of $5,000 merchandise	$ 6,666
Total sales	30,000
Turnover	4½ times

When compared with the average turnover in the industry as a whole, the turnover of an individual enterprise serves as an index of relative business efficiency. If the turnover in a given case is found to be below the average, it would tend to indicate one of four things:

(a) The inventory, or merchandise, has been overvalued.
(b) Too large a stock is being carried.
(c) It partly consists of old, unmovable stock.
(d) The selling efficiency of the merchant is below average.

2. The merchant's ability as a collector may be estimated by making a comparison of the accounts receivable with the annual sales, based on the terms of payment, thus:

Accounts receivable	$12,000
Annual sales	144,000
(Monthly sales $12,000)	
Trade terms	30 days net

The accounts receivable should run approximately $12,000 a month, showing the merchant in this case to be a very good collector. When the receivables seem unduly large and out of proportion, the presumption arises that the amount listed on the financial statement includes a number of old and uncollectible debts.

3. By making a comparison of present figures with the corresponding figures reported for previous years it is possible to tell whether the business is progressing or retrograding (see Chapter XV).

4. When available, a comparison may be made of the total expenses with the volume of sales, which affords a criterion whereby to judge whether or not the business expenses are

in proper proportion to the gross profits, that is, whether the merchant is making a net profit.

5. A comparison of his average monthly sales with the amount of stock carried will tend to show whether he is a careful buyer, or has a tendency to overbuy—so often the direct cause of insolvency.

CHAPTER XII

ANALYSIS OF CORPORATE FINANCIAL STATEMENTS

Statements Defined

The two principal financial statements compiled by a corporation are the balance sheet and the income or profit and loss statement, the purpose of both being fundamentally the same, namely, to show the actual condition of the business at a given time, in highly condensed, though in different forms.

The balance sheet shows the financial condition of a corporation at a particular time, and from a technical point of view purports to show the assets which it owns together with, and in contrast to, the liabilities which it owes. It indicates the solvency of the business but gives no information as to the earnings or expenses of operation.

The income or profit and loss statement accounts for and explains the changes that have taken place in the finances of the business since the date of the last balance sheet. Theoretically, it is supposed to supplement the balance sheet.

Relation to One Another

It is a well-established fact that the powers of even the most gifted are limited, and as the true condition of the business is determined not by any particular item of information but by the relation that exists between numerous items, the elimination of unnecessary details from the face of the balance sheet serves to facilitate the analysis whereby the relation is ascertained. It is therefore important to supplement the main statement or balance sheet, when possible, with the more detailed information contained in the income or profit and loss

statement, as a means of explaining the various items that appear on the former. These two basic reports are, therefore, complementary to each other and of most value when studied together. While the credit man is principally concerned with the former in extending credit, it is because it as a rule is the only one of the two reports that is available, and not because of any lack of interest in the other.

The difference in the situation reflected in these two statements has been likened unto the measurement of the contents of a tank of water from time to time. Assuming an inflow and an outflow pipe, changes in the volume of water may be determined either: (1) by comparing the actual level of the water for different periods; or (2) by comparing the total inflow with the total outflow.

Construction of the Balance Sheet

The ultimate purpose of the balance sheet, as previously stated, is to show the relation that exists between the assets and liabilities as of a given time. Struck off at certain intervals, the balance sheet has been said to present a kind of "cross-sectional view" of the business condition at these intervals, inasmuch as it records the gains and losses, which may be due to either a change in the value of the assets or to an opposite change in the amount of the liabilities, or to both.

Knowing the purpose a balance sheet is to serve, the next problem is as to the manner in which the information may be set forth to greatest advantage to accomplish this purpose. All credit men are more or less familiar with the construction of the typical balance sheet, and yet even experienced credit men are frequently confronted with statements containing items of undiscernible meaning, but the mystifying character of which quickly disappears when the true function of the item in question is ascertained and understood. This is true as to both assets and liabilities.

The present-day tendency is for corporations to publish

their balance sheets regularly at periodic intervals, owing to the increasing demand for publicity in connection with corporate affairs, and as a result the balance sheet has become one of the principal criterions upon which credit men base their inferences and conclusions in determining the inherent risk in extending credit to corporations.

Assets

Corporate assets naturally fall into three classes, based upon the manner in which they function within the business:

1. Those of a permanent or fixed nature, which the business has acquired and which undergo but slight change from month to month or year to year, designated "fixed" assets, such as real estate and improvements thereon, equipment, and fixtures.
2. Another class consists of those assets which are readily available and used for the purpose of discharging current liabilities incurred in the operation of the business, and are therefore termed "current" or "quick" assets, such as cash, accounts receivable, notes receivable, and the inventoried merchandise.
3. The third class consists of credits which have been obtained as a result of certain payments made for benefit of future periods, or certain fixed charges paid in advance, which are called "deferred" assets, such as taxes, interest, and insurance premiums paid in advance.

Arranged in statement form, the construction of the asset side of a corporate balance sheet may therefore be outlined as follows:

Fixed Assets
  Land
  Buildings
  Equipment
  Fixtures

CURRENT ASSETS
Cash
Accounts Receivable
Notes Receivable
Merchandise

DEFERRED ASSETS
Taxes Paid in Advance
Rent Paid in Advance
Interest Paid in Advance

Liabilities

On the liability side of the balance sheet we find classified in a very similar manner the debts of the corporation under the corresponding headings of: (1) "fixed" liabilities, or those which do not have to be met in the immediate future, such as mortgage debts and bonds; (2) "current" liabilities, or those which have to be met promptly and paid out of the current assets, such as accounts payable and notes payable; and also (3) what are termed the "capital" liabilities, or the par value of the outstanding capital stock and surplus. These capital liabilities constitute a secondary rather than a primary liability—corresponding to the net proprietorship, or what the business owes to the proprietor—but inasmuch as they partake of the nature of a liability, they are properly classified as such.

The liability side of the balance sheet may, therefore, be outlined as follows:

FIXED LIABILITIES
Mortgage Bonds

CURRENT LIABILITIES
Accounts Payable
Notes Payable
Accrued Taxes
Accrued Rent

CAPITAL LIABILITIES
Common Stock
Preferred Stock

Of course, all balance sheets do not conform strictly to this general outline, but whatever variations are presented will be found to be differences of terminology and form rather than of principle or substance.

Corporate Surplus

The excess of the total assets over the total liabilities as thus classified will therefore represent the surplus, or credit balance of the business. So in order to bring the statement into balance it is necessary to add this amount to the listed liabilities. In other words, the surplus is an excess of assets carried as a nominal liability merely to bring the statement into balance and connotes profits from prior business dealings.

Net Worth

The net worth of any corporation is that amount which is the difference between the sum of all the assets and the liabilities, and it is determined by adding together the capital stock outstanding, surplus, accumulated profits, and surplus reserves. The resultant also incidentally represents the total book value of the shares of stock outstanding.

If the sum of the liabilities, exclusive of the capital stock outstanding, the accumulated profits, and the surplus, exceeds the sum of the assets, the difference is the amount by which the capital stock outstanding has been impaired.

Theory of Analysis

Once the theory of the construction of a corporate balance sheet is understood, the analysis whereby the desired information is obtained is not difficult. In fact, the theory of the analysis of the corporate statement is substantially the same as the theory that has been set forth in a preceding chapter as applied to the ordinary property statement submitted by a partnership, unincorporated association, or the sole proprietor —the process whereby two things are ascertained:

1. The factors insuring the prompt payment of one's account as the bills fall due.
2. The protection afforded by the equity in the fixed assets in event of an ultimate forced liquidation of the business—the ultimate payment of the account, however, being of less immediate concern than the regular payment of one's bills as they fall due.

The manner in which this information is obtained is also fundamentally the same as in the other forms of business. The former of the two propositions, as previously explained (see page 123), is directly dependent upon the amount of working capital available for the handling of one's account, and is determined by ascertaining the difference betweeen the current assets and the current liabilities, as so classified in the statement, the current assets usually consisting of:

Cash
Merchandise
Raw Materials
Goods in Process
Accounts Receivable
Notes Receivable

The current liabilities usually consist of:

Accounts Payable
Notes Payable
Accrued Taxes
Accrued Rent

The importance of giving first consideration to the current assets has already been discussed, the reason for it being that the credit man must primarily look to them for the regular payment of his account. Insolvency is just as likely to result from the inability of an otherwise strong corporation to meet its current expenses because of insufficient cash as in the case of a partnership or that of a sole proprietor. In a similar manner the equity in the fixed assets is also determined by

ascertaining the difference between the fixed assets and the fixed liabilities, as so classified on the statement.

Before arriving at a decision as to the true status of the corporate finances, however, due consideration should also be given to such other items as the deferred assets, reserves, and accumulated surplus, the significance of which and the extent to which they enter into and modify the primary conclusions arrived at by the credit man will become more apparent after these various items have been discussed in detail.

Factors Determining the Amount of Working Capital

How is it possible to calculate in advance the amount of working capital required in a business, and upon what factors does this determination depend? Owing to the fact that the proportion of working capital required in certain lines of business is greater than the proportion required in other lines, it is not possible to prescribe an exact formula in answer to this question, but there are certain well-recognized factors that must be taken into consideration, which are as follows:

1. Volume of Business. Other things being equal, the proper proportion of working capital in a business will vary in proportion to the volume of sales. Or, to put it in another way, the larger the volume of business transacted the greater the amount of cash capital required.

2. The Regularity with Which Business Can Be Obtained and Disposed Of. Where the nature of the business is such that the volume of sales remains more or less constant throughout the year the regular income takes care of the regular outgo; but where the business is of a seasonal nature, it is quite obvious that a larger amount of working capital is required during the dull season, if the merchant has an accumulated stock on his hands, than during the active season when his stock is low. This factor increases the complexity of the situation and greatly affects the amount of working capital needed in a business.

3. Length of Period of Production. A business in which a long period is required to turn out the product requires that large amounts of working capital be tied up in the process of manufacture. This consequently constitutes another important factor in determining the amount of working capital needed in a business. "A breadmaker does not risk as much in proportion to the volume of his business as does the leather manufacturer, for he has scarcely paid for his flour and labor before the receipts from his sales flow back to him."

4. Terms of Purchase. Consideration must also be given to the terms of credit upon which the company purchases its goods, for it is obvious that where a concern sells its product on longer credit terms than it receives from the firms it purchases from, a greater amount of working capital is required than where the contrary is true.

(a) Suppose A makes it a practice either to pay cash, or within the discount period, for the goods he carries in stock, while he resells them on 30 days' credit.

(b) Suppose B purchases the goods he carries in stock on 30 days' time and resells them for cash.

Obviously, the amount of working capital required by A to finance his business will be greater than the amount required by B.

5. Terms of Sale. As a corollary to the principle established in the preceding section, it may be added that "the longer the period of credit extended in the resale of the product, the larger must necessarily be the amount of working capital required." This factor becomes of special importance in considering the amount of working capital required in an enterprise that is concerned principally in the sale of its product in foreign countries.

6. Hazards of the Business. Where the nature of the product is such that it is subject to frequent and violent market fluctuations, an ample reserve supply of working capital is necessary to serve as a protection against unlooked-for losses

due to market declines, and to carry the business through periods of liquidation.[1]

Valuation of Balance Sheet Items

After the amount of working capital in the business has been determined, and likewise the prima facie equity in the fixed assets, the credit man should proceed with his investigation until he has clearly established the true relationship that exists between the assets and liabilities. This involves a further consideration of the various items that usually appear on a corporate balance sheet.

The nature, character, and function of the current and fixed assets, together with the current and fixed liabilities, has already been fully discussed in the preceding chapter, so our further consideration of the subject may be restricted to those items which have not previously been discussed, particularly the capital and surplus liabilities which are pregnant with significance and usually merit the most careful consideration.

Intangible Assets

It is the common practice of accountants to include under the general term "fixed" assets, such items as good-will, patents, franchises, etc., all of which are of an intangible nature as distinguished from the other assets. Concerning the valuation of good-will as a business asset, one writer has said:

> The measure of value, in pecuniary terms, of this intangible thing, is the difference between the value of the normal results of the working of any business or profession which may be established by, and as worked by, any person in any place, and the result of working any individual business of a similar character. Thus, given a business, the good-will of which is for disposal, there would be no valuable good-will if any one could do just as well by establishing a business anew. To start a business has its risks, which may often be described as very serious risks, but apart from the mere perilous risks of failing to take

[1] See Lough's Business Finance, Chap. XVII.

> proper root, there is the often weary time—sometimes a long term of years—during which a sufficient connection is being got together to bring the business up to a standard paying basis which will give a good-will value, or bring a good-will value into sight. To be spared this period of what I may call perilous probation is something worth paying for, even though its maintenances from this point needs the continuous energy and industry by which it was built up by the original proprietor. Time, money and anxiety saved is money made. This is what is worth paying for, and in this degree a good-will value attaches to an established business.

That such resources are valuable assets in a business is not to be questioned; but from the point of view of the credit man in extending credit, they constitute a negative quantity because to a going concern they are not available for debt-paying, and to an insolvent concern they are usually worthless.

Capital Liabilities

When a corporation first comes into existence, the initial funds with which it is to function are obtained from the issue of capital stock and possibly the sale of bonds. The fundamental distinction between these two corporate instruments is that bonds are the corporation's debts, while the capital stock of a corporation represents the aggregate ownership therein, and is usually, although not necessarily, divided into units called "shares"—each share representing a contract between the holder of the share certificate and the corporation. This contract does not provide for the repayment of the par value or purchase price of the share at any specified time, but represents an agreement whereby the holder is to participate and share in the profits of the business in relative proportion to his capital holdings. If there is no binding promise on the part of the corporation to repay the par value of the share, why should the capital stock as represented thereby be considered and listed as a corporate liability? Because of the underlying theory that upon the disssolution of the business the par value

of the stock, together with a pro rata share of the surplus remaining, will be returned to the stockholders.

Capital Stock

The amount of this item should represent the face value of stock issued and outstanding. Sometimes, however, it includes the face value of all the stock authorized to be issued, even though some of the stock remains unissued. Stock which has been issued and later purchased back or returned to the corporation should be shown as a separate item on the asset side of the balance sheet as treasury stock. Treasury stock, from the credit man's viewpoint, may be considered as an asset only so long as the company continues prosperous or remains in a healthy financial condition, for in case of insolvency the treasury stock would become worthless.

The stockholders are not creditors of a corporation inasmuch as no legal responsibility for the return of the money to them rests on the company and in event of insolvency the general creditors must be paid before anything is realized out of the assets by the stockholders. Capital is, therefore, neither an asset nor a liability within the strict meaning of these terms.

When the true liabilities are deducted from the true assets, the result represents the undivided profits plus the capital; and as dividends may only be paid out of the surplus or undivided profits, the capital must be deducted before dividends can be declared. Where, however, a certain amount of the surplus has been appropriated to the business and is not available for dividend distribution, it is generally carried as a separate item, "capital surplus."

Furthermore, the capital of a corporation does not represent a trust fund in the ordinary sense of the word. The assets of a corporation are not held in trust either for the stockholders or creditors. It constitutes a trust fund only in the sense that it must first be accounted for before dividends are declared. A corporation owns property just like an in-

dividual, and it can do with it as it pleases so long as it does not become insolvent. But before any money in the nature of dividends is paid to the stockholders, the capital must be kept intact. It is the sole security on which a creditor can rely.

Bonds

A corporate bond is a capital obligation of different character. It is a corporate liability in the strict sense, being a promise under seal to pay a specified sum of money (the amount of the bond) at a fixed future time (usually more than ten years after the promise is made), and carrying a fixed rate of interest. As security for the faithful performance of such promise a so-called "deed of trust," or mortgage, may be executed, whereby a certain portion of the corporate property is mortgaged to a trustee for the benefit of the bondholders. Consequently, if there is a bonded indebtedness the time of maturity of the bonds must be considered, also whether or not their payment is being provided for by means of an accumulated fund for their redemption.

Reserves

There are three classes of reserves as follows:

1. Valuation reserves which are merely offset to assets and not really liabilities, such as depreciation reserves.
2. Reserves which are liabilities in the strict sense of the term, such as the reserve for taxes.
3. Reserves which in reality constitute a part of the surplus, such as the reserve for contingencies.

Depreciation is a cost that is not always provided for in such manner, and as a result it has been known to become a source of serious financial embarrassment to the corporation.

Surplus

In the case of the partnership or sole proprietor the net worth, or excess of the total assets over the total liabilities,

"Large assets are not always necessary to the creation of credit; what is most desirable is that credit be in relative proportion to the actual assets."

PROPERTY STATEMENT

TO

"The giver of credit is a contributor of capital, and becomes, in a certain sense, a partner of the debtor, and, as such, has a natural right to complete information of the debtor's condition at all times."

Form Adopted and Recommended by the National Association of Credit Men

For the purpose of obtaining merchandise from you on credit, I (we) make the following statement in writing, intending that you should rely thereon respecting my (our) financial condition as of (Date) ....19....

(All questions should be answered. When no figures are inserted, write word "None.")

ASSETS		
Cash in hand	....	....
Cash in bank	....	....
Accounts owing by customers, good and collectible, not pledged or sold	....	....
Notes owing by customers, good and collectible, not pledged or sold	....	....
Trade Acceptances receivable, not pledged or sold	....	....
Merchandise: (not on consignment or conditional sale.) (How valued; Cost.... Market....)	....	....
Other quick assets: (Describe)	....	....
....	....	....
....	....	....
TOTAL QUICK ASSETS	....	....
....	....	....
Machinery: (How valued; Cost.... Depreciated....)	....	....
Fixtures and other Equipment. (How valued; Cost.... Depreciated....)	....	....
Land and Buildings as described below	....	....
....	....	....
Notes and Accounts owing from members of firm, employees, or others not customers	....	....
Other assets: (Describe)	....	....
....	....	....
....	....	....
TOTAL ASSETS	....	....

LIABILITIES		
For MERCHANDISE:		
Accounts owing not due	....	....
Accounts owing past due	....	....
Trade Acceptances payable	....	....
Notes payable for Mdse	....	....
For BORROWED MONEY:		
Notes payable to banks	....	....
Notes or debts payable to others (including relatives and friends)	....	....
Deposits of money with us. (Describe)	....	....
Owing for Wages and Salaries	....	....
Owing for Taxes (city, state and federal)	....	....
Owing for Rental	....	....
Owing for Insurance Premiums	....	....
TOTAL QUICK LIABILITIES	....	....
....	....	....
Debt secured by mortgage on land or buildings	....	....
Debt secured by chattel mortgage or other liens	....	....
Debt secured by judgment	....	....
Other liabilities: (Describe)	....	....
....	....	....
TOTAL LIABILITIES	....	....
NET WORTH — *Capital Stock: Preferred	....	....
NET WORTH — *Capital Stock: Common	....	....
NET WORTH — Surplus and Undivided Profits	....	....
TOTAL	....	....

What books of account do you keep?..

Was this statement made from those books?................ Do you keep cost records?................

Do you sell or pledge your accounts to creditors, banks, finance companies or others?........ If so, what amount is so sold or pledged? $.......... What amount of your accounts have you sold or pledged during the past twelve months? $........

Are any creditors secured by mortgage or lien or any sort?................ If so, how?................

....

Are any claims in attorneys' hands or suits against you?..

Have you merchandise on consignment or conditional sale?.......... If so, what amount? $...........

If business property is leased, for what term and what rental?..

Name and locality of your bank or banks..

Location and kind of business..

Is your business incorporated?.................... If so, under laws of what state?................

Previous business experience.................................... Where................

It is important that every question on both sides of this sheet be correctly answered and that the blanks be carefully filled in. In answering questions involving amounts write the word "none" where figures do not apply. You will find it advantageous to keep a copy of this statement for comparison with the showing you will be able to make a year hence.

* Capital stock item to be filled out only by corporations.

Form 7. Standard Form of Corporation Balance Sheet

INSURANCE

On Merchandise $.......... On Buildings $.......... Machinery $.......... Fixtures $..........
Other Equipment $.............................. Employers' Liability $..........................
Is any insurance assigned?.......... What amount?.......... To whom?........................
Amount of life insurance for benefit of business $..
With what companies....... ....

SUMMARY OF PROFIT AND LOSS

Inventory of Mdse. beginning of fiscal year (not including fixtures or equipment).........	....	...	Sales last fiscal year..................	....	...
Cost of Mdse. purchased during the year.	....	...	Income from all other sources.........	....	...
General expenses including salaries, losses, etc........................	....	...	Inventory of Mdse. at close of year....	....	...
			Total Income for year................	....	...
			Less Total Expenses..................	....	...
TOTAL EXPENSES....	....	...	NET PROFIT FOR YEAR....	....	...

RECORD OF LAND AND BUILDINGS

Title in name of	Description and location	Book value	Assessed value	Amount of Encumbrances	To whom
....	....	....	....	....	....
....	....	....	....	....	....
....	....	....	....	....	....
....	....	....	....	....	....

BUY PRINCIPALLY FROM THE FOLLOWING CONCERNS

Names	Addresses	Amount Owing			
		Open Account		Notes	
....	....	....	....	....	....
....	....	....	....	....	....
....	....	....	....	....	....
....	....	....	....	....	....
....	....	....	....	....	....

Names and Addresses of Partners, or if Corporation, of Officers..................................
....
....

REMARKS:

The foregoing statement has been carefully read (both printed and written matter) and is in all respects complete, accurate and truthful. It discloses to you the true state of my (our) financial condition on the date above stated. Since that time there has been no material unfavorable change in my (our) financial condition; and if any such change takes place I (we) will give you notice. Until such notice is given, you are to regard this as a continuing statement.

Name of Individual, Firm or Corporation..

Signed by..

Street..................Town................State...........

Date of signing statement....................19....

Form Jt.

Adopted by the National Credit Men's Association

represents a sort of secondary liability—what the business owes the proprietory or proprietors, so to speak. Corresponding to such a secondary liability in the case of the partnership or sole proprietor, we have the "surplus" item carried on the corporate balance sheet, which, to carry out the analogy, may be said to represent the accumulated profits available for distribution among the stockholders. No legal duty, however, rests upon a corporation to distribute its surplus; it is a discretionary power vested in the board of directors. Neither the proprietorship or the surplus item is a liability in the strict sense, because it is not a debt the payment of which may be forced by process of law. It is merely a nominal liability.

Form of Corporate Balance Sheet

Considerable latitude is permitted in drawing a corporate balance sheet. An approved simple form and one very frequently adopted is the following:

Assets		*Liabilities*	
CAPITAL ASSETS		CAPITAL LIABILITIES	
Land..................	$......	Bonds................	$......
Buildings.............	......	Preferred Stock.........	......
Machinery and Equipment...............	......	Common Stock.........	......
Furniture and Fixtures..	......	CURRENT LIABILITIES	
Good-Will, Patents, etc..	......	Accounts Payable.......	......
CURRENT ASSETS		Notes Payable..........	......
Finished Goods.........	......	Owing to Banks........	......
Raw Materials..........	......	Accrued Wages, Rent, etc..................	......
Cash..................	......	RESERVES	
Accounts Receivable....	......	Depreciation of Equipment...............	......
Notes Receivable.......	......	Depreciation of Buildings	......
DEFERRED ASSETS		For Doubtful Accounts..	......
Prepaid Taxes..........	......	SURPLUS................	......
Prepaid Insurance.......	......		
Prepaid Rent..........	......		

Form 8. Balance Sheet of a Corporation

The National Credit Men's Association has adopted a standard form of statement for the use of corporations. This is shown in Form 7 on pages 156 and 157.

CHAPTER XIII

INCOME OR PROFIT AND LOSS STATEMENT

Function of the Statement

The income or profit and loss statement, when available, yields certain information to the credit man that cannot be obtained from a balance sheet, because it is conditioned upon a more detailed and extended statement of facts. The volume of business done, the yearly turnover, the operating ratio—these and various other items of interest to a credit man can be derived from an income statement, when properly analyzed.

Once obtained this statement ought always to be preserved and used as a basis for comparison with those submitted later in order to determine the underlying trend or tendencies of the business. Taken over a period of several years, well-defined tendencies or constructive policies in the conduct of the business are unmistakably reflected in the changes that are recorded in the income statement, because it sets forth in analytical form the sources of both profits and losses, and the ultimate profit or loss, as the case may be. A balance sheet does not purport to account for the direct sources of profits and losses, its exclusive function being to show the effect upon the classified assets and liabilities of the changes that have transpired in the business finances during the interval as accounted for by the income statement.

Construction of the Profit and Loss Statement

The following outline may be considered as the most common or typical form of corporate income statement. It starts out with the gross earnings, or the amount realized from the gross sales of its product, and proceeds in orderly manner to

add and deduct the various sources of revenue and expense until a correct balance, representing the corporate surplus, is arrived at.

1. Amount Realized on Gross Sales		$100,000
Deduct: Cost of the Goods Sold		40,000
2. Gross Profit on Sales		$ 60,000
Deduct: Selling Expenses:		
Salaries	$......	
Traveling Expenses	......	
Commissions	......	
Advertising, etc	......	25,000
3. Selling Profit		$ 35,000
Deduct: Administrative Expenses:		
Salaries of Officers	$......	
Salaries of Employees	......	
Directors' Fees	......	
Printing and Stationery	......	
Telephone and Telegraph	......	
Legal Services, etc	......	15,000
4. Net Return from Operations		$ 20,000
Add: Other Income:		
Interest on Securities Owned	$......	
C/D on Purchases	......	
Interest on Bank Balances, etc	......	10,000
5. Total Income or Earnings		$ 30,000
Deduct: Fixed Charges:		
Interest on Bonds	$......	
Interest on Notes	......	
Insurance	......	
Taxes, etc	......	5,000
6. Net Earnings		$ 25,000
Deduct: Reserves:		
Depreciation for Doubtful Accounts	$......	
Depreciation of Equipment	......	
Depreciation of Buildings	......	5,000

7. Profit and Loss Surplus (for Year —— to ——)	$ 20,000
Add: Profit and Loss Surplus from Previous Years	10,000
8. Gross Surplus	$ 30,000
Deduct: Dividends Declared	10,000
9. Present Corporate Surplus	$ 20,000

Reduced to its simplest form, the income statement may be set forth as follows:

Gross Sales or Income	$
Operating Expenses	
Net Income	$
Fixed Charges	
Surplus for Year	$
Surplus from Previous Years	
Corporate Surplus	$

Gross Sales or Earnings

Gross sales or earnings, strictly speaking, includes only the income derived from the concern's principal line of business. Income from collateral or supplemental sources, such as that from securities, rentals, etc., is properly included in the separate item, "other income," which, when added to the difference between the gross sales and the operating expense, gives the "total income."

Gross sales may be said to measure the success of the business to the extent that they will promptly reflect any decline in prosperity. In other words, they are large or small, and increase or decrease in direct proportion to the success of the business, which in turn largely depends upon the rapidity with which the merchandise is turned over. The reason for this is that an increase in the rate of turnover not merely increases

the gross income, but it also reduces the proportionate expense of handling the merchandise. It simply represents another phase of the economic law of increasing and decreasing returns as applied to the sale of merchandise, for rarely does the expense of doing business increase proportionately with the growth of sales, and rarely, on the other hand, does it decrease proportionately with a falling off of sales. This is true because many charges, such as taxes, depreciation, etc., remain approximately the same in amount irrespective of the volume of business transacted.

The significance of this item to a credit man is that changes in the volume of income should be carefully noted and studied in the light of existing and probable future business conditions.

Gross sales should include all goods sold during the period under consideration, as modified, however, by goods returned and price adjustments.

In order to determine the efficiency of the business management, a comparison is made between the total volume of sales and the amount of the final inventory, on the theory that the presence of an unusually large inventory would tend to indicate, although not necessarily, poor management in permitting the unsold stock to accumulate in excess of the market demand for the goods. For example, assuming that a corporation reports annual sales amounting to $500,000, and the merchandise on hand at the end of the period amounting to $200,000, the natural inference would be that the concern was carrying too large a capital investment in stock-in-trade. This is, of course, merely an inference and by no means to be taken as conclusive evidence of inefficiency, because it is entirely possible that such a condition may reflect efficiency instead of inefficiency on the part of the management in stocking up merchandise at advantageous prices for use in supplying a later period—anticipating the market, so to speak.

However, such a condition discloses what is commonly referred to as "speculation in inventory," which may be said to

consist in the purchase of a larger quantity of merchandise than will be consumed by normal sales within a reasonable period. A large inventory always lays a business open to the danger of large losses from the shrinkage of market values.

Cost of the Goods Sold

The cost of the goods sold is found by taking the inventory of finished goods on hand at the beginning of the period, adding the cost of the goods manufactured during the period under consideration, and then deducting the value of the finished goods on hand at the end of the period. In the equation form the formula is as follows:

Cost of goods sold = Goods on hand at beginning of period + Cost of goods manufactured during period — Volume of finished goods on hand at end of period.

The formula may be put in another form of equation, thus:

Cost of goods sold = Cost of goods manufactured + Difference between inventory of finished goods at the beginning of period and that at end of period.

This item, cost of goods sold, is also used as the basis for calculating the turnover of the capital invested in merchandise, by dividing it by the merchandise inventory, as already shown. Manifestly, the greater the rate of turnover the larger the return on the capital investment. Consequently, the turnover may be accepted as an authentic criterion of the management's business efficiency when compared with that of preceding periods.

Gross Profit

As shown by the outline, the difference between the income from sales and the cost of the goods sold represents the gross profit on sales. In determining the percentage of gross profit on sales, either the cost of the goods sold or the gross sales may be used as a basis. The result, however, is of particular significance only as a comparative figure and when taken into

consideration with the corresponding figure of prior periods. When so used it will disclose either an increase or decrease in the percentage of gross profit, and the reason for the change is always of interest to a credit man.

Selling Expenses

This item should include all the expenses of marketing and distributing the goods sold. In examining this item, the credit man should consider it in comparison with the volume of sales, in order to determine whether or not it is in proper proportion. If it is found to be too large, a logical inference is that the business is being carried on under too great an overhead expense and that it is organized on an unprofitable basis. Too great reliance is not to be placed on this figure, however, because there is no uniform basis for calculating selling expenses, and the problem is primarily one of accurate cost-finding. Given, however, a uniform cost system over an extended period, any appreciable increase or decrease in the percentage of sales expense becomes significant.

Administrative Expenses

The next group of expenses are those which have to do with the management of the enterprise. They are made up of those expenses which cannot be directly apportioned either to manufacturing or selling activities, but the benefit of which accrues to both branches of the business.

In connection with this item it is important to know that the cost of supervising the establishment bears a proper relation and is in proper proportion to the cost of manufacture, the selling expense, and the volume of sales; but in order to determine this, it is necessary, as a condition precedent, that the credit man should know approximately what constitutes an average overhead administrative expense of concerns engaged in similar lines of business. Once this is known, significant comparisons may be made.

Summary

So far we have seen that we start out with the gross income from sales, and then deduct the selling and administrative expenses, which taken together will hereafter be referred to merely as the operating expense. The result, as will be noted by reference to the outline, is what is termed the "net profit" from sales; or, as it will be hereafter referred to, the "net income." These are the three important factors to be considered in analyzing a comparative income or profit and loss statement.

Operating Ratio

The item, "operating expense," when construed in relation to the gross income, serves as a very useful basis of comparison and an index to the business efficiency of the company, when made over different periods of a concern's history, and also when used as a basis for comparing the relative efficiency of different companies engaged in the same line of business. The ratio of the operating expense to the gross income is termed the "operating ratio."

Example:

Gross income reported to be............	$100,000.00
Operating expense......................	60,000.00

Operating ratio = 5:3

This means that it costs the company on an average $3 to sell $5 worth of goods.

As a rule, a decline in the operating ratio may be construed as indicating some improvement in the conduct of the business, such as would be reflected by an increased rate of turnover. This should be a mere presumption, however, as the decrease may have resulted from some temporary economy that is being practiced and which will ultimately prove detrimental rather than beneficial to the welfare of the business, such as, for example, the failure to set up a sufficient reserve for depreciation. The value of the operating ratio for comparative purposes may be largely reduced by lack of a uniform system of

accounting; but, on the other hand, if the corporation has maintained a uniform system of accounting over an extended period, valid comparisons may be made between two or more years.

Interpretation of Net Income

By deducting the operating expense from the gross income we obtain the net income, and it is from the net income that the fixed charges must be met. It is therefore obvious that if too great a proportion of the gross income is allocated to operating expenses, or the fixed charges are too great in proportion to the volume of business transacted, it is at least possible that the net income may be insufficient to meet the fixed charges. It is for this reason that bondholders generally require a margin of safety in the net income amounting to at least twice the sum required to pay the interest on the bonds.

Net income also constitutes the primary source of dividends to be paid to stockholders, although when the corporation has set aside during years of prosperity a surplus for this particular purpose, dividends may be paid out of the surplus when the net income proves insufficient. A striking illustration of this point is to be found in the financial policy of the American Car and Foundry Company, which during the war and post-war period set aside as a special appropriation a fund sufficient to maintain the regular dividend rate for several years. Unless such a special appropriation is set aside, the policy of paying unearned dividends out of the surplus, which is very common, may injuriously reduce the working capital of the business, and instead of serving to maintain their credit responsibility, may seriously jeopardize it.

Other Income

By adding the revenue from collateral sources, such as interest and dividends received on securities held, discounts on purchases, rents, royalties, etc., we obtain the total income.

Any and all items of income, other than that derived from the sale of the company's product should properly be included under "other income."

Fixed Charges

The fixed charges are not likely to present any considerable misstatement of values, inasmuch as the determination of their amount is largely beyond the control of the management. The significance of this item lies rather in the comparative amount.

Net Earnings

By deducting the amount of fixed charges from the total income we get the net earnings; and in order to obtain the year's surplus, all that remains to be done is to deduct the special reserves which have been established to cover depreciation, abnormal losses, etc.

Corporate Surplus

Assuming a surplus has been accumulated during prior years, by adding the year's surplus to the surplus carried over at the beginning of the year, the gross corporate surplus is obtained, and should check with that item as shown on the balance sheet.

Analysis of Surplus Fluctuations

If the costs and expenses of the year have been greater than the total income received, the operations have resulted in a deficit. This not infrequently occurs, and occasions no great financial embarrassment to a corporation which has a surplus carried over from previous years.

The conversion of such a deficit from operations into a surplus in the succeeding period, however, should be carefully inquired into. This might be brought about by inflation of the inventory, and if a comparison of the inventory showed that it had increased in a much greater degree than the increase

in the accounts and notes payable, it could reasonably be inferred that an inflation of the inventory was responsible for the change. Comparative statements taken over a period of years will usually disclose practices of this sort where a statement for a single year would be useless.

CHAPTER XIV

LAWS ON PUBLICATION OF FINANCIAL STATEMENTS

States Requiring Publication

An examination of the corporation laws of the various states and territories of the United States discloses the fact that very few have enacted laws requiring corporations to publish financial statements. Annual publication of corporate reports are required in these states and territories:

ALASKA

Exceptions: Foreign corporations.

Date of Publication: Within 30 days after date fixed for stockholders' annual meeting.

Nature of Publication: Newspaper of general circulation published nearest to place of transaction of business.

Report Verified By: President and treasurer.

For Failure to Publish: Such officers who neglect to publish after written request to do so by a creditor shall be under penalty of $50 for every day in default, recoverable by aggrieved creditor.

DISTRICT OF COLUMBIA

Exceptions: Domestic insurance corprations. Foreign corporations not exempt.

Date of Publication: January 1–20.

Nature of Publication: Newspaper in the district.

Report Verified By: Oath of president or secretary.

Report Signed By: President and majority of trustees.

For Failure to Publish: Any creditor may by petition for mandamus against the corporation and its proper officers compel such publication. Corporation or officers at fault must stand all expenses.

Publication of False Report: If false in any material representation all officers who shall have signed the statement, knowing it to be false, shall be jointly and severally liable for all debts contracted while they are stockholders or officers.

Nebraska

Exceptions: Domestic religious societies, foreign corporations.

Date of Publication: Annually.

Nature of Publication: Newspaper of general circulation in the country where principal office of the corporation is located.

Report Verified By: An oath of president and secretary.

For Failure to Publish: No provisions.

Publication of False Report: No provisions.

Nevada

Exceptions: Domestic corporations.

Date of Publication: Not later than March of each year.

Nature of Publication: Newspaper published in the state. If a daily paper, publish for a week; if a semi- or tri-weekly paper, publish for 2 weeks; if a weekly paper, publish for 4 weeks.

Report Verified By: No provision.

For Failure to Publish: No provision.

Publication of False Report: No provision.

North Dakota and South Dakota

Exceptions: Domestic corporations not engaged in mining, manufacturing, or other industrial pursuits. Foreign corporations are not exempt unless engaged in pursuits not mentioned above.

Date of Publication: January 1-20

Nature of Publication: Newspaper published at or nearest to the place where the business is carried on.

Report Verified By: Oath of president or secretary.

Report Signed By: President and majority of directors.

For Failure to Publish: Any person who wilfully neglects, fails, or refuses to make, sign, or publish the report is guilty of a misdemeanor.

Publication of False Report: No provision.

Tennessee

Exceptions: Foreign corporations.

Date of Publication: During month of January.

Nature of Publication: Newspaper in county of principal office.

Report Verified and Signed By: No provision.

For Failure to Publish: No provision.

Publication of False Report: No provision.

Summarizing, we find that Alaska, District of Columbia, Nebraska, Nevada, North Dakota, South Dakota, and Ten-

nessee are the only states or territories that require corporations to publish financial statements.

Other Statutory Provisions

There are a few other states, however, which have provided another way of protecting creditors, and that is by requiring

State	Title of Official with Whom Filed	Date of Filing	Corporations Exempt
Alaska	Secretary of the District	Within 60 days from January 1	Domestic corporations
Arizona*	Corporation Commission	During June	No exceptions
Arkansas	County Clerk, county where business transacted	February 15 or August 15	Foreign corporations
Colorado	Secretary of State	Within 60 days after January 1	No exceptions
Hawaii	Treasurer of Territory	Domestic corporations, within 60 days after January 1 Foreign corporations, July 1	Charitable, religious, literary, educational, or corporations promoting amateur athletics
Kansas*	Secretary of State	On or before March 31	No exceptions
Massachusetts	Commissioner of Corporations	Within 3 months after annual meeting	No exceptions
Michigan	Secretary of State	January or February	No exceptions
Missouri	Secretary of State	On or before July 1	Express and insurance companies and companies exempt from taxation
Montana	County Clerk in county where business is located	By March 1	Domestic banks, trust companies, and building and loan associations
New Hampshire	Secretary of State	By March 1	No exceptions
New York	Secretary of State	During January	Railroad and moneyed corporations
Ohio	Recorder of county where business is located	During January	No exceptions
Pennsylvania*	Auditor General	On or before last day of February	Banks, insurance, and trust companies and building and loan associations
Porto Rico	Treasurer of Porto Rico	By March 15	No exceptions
Vermont	Secretary of State	By March 1	No exceptions

* These reports are required for tax purposes.

corporations to permit creditors to examine such records and books of account that would be of direct importance to their claims. Missouri, New Hampshire (creditor's attorney also has this right), and Oregon have made this provision in their corporation laws.

A number of the states and territories require corporations to render financial statements to state officials, with whom they are recorded and filed. It is possible that such state officials might furnish creditors with copies upon receiving written request to do so. However, this point is not provided for in the statutes. The table on page 171 shows the states that have enacted laws requiring corporations to file financial statements, the title of the official with whom they must be filed, the date of filing, and the corporations exempt.

Statements to Stockholders

The following states require corporations to submit financial statements to their stockholders of record:

California. Upon the written request of not less than 10 per cent of the stockholders, given not less than two weeks before the annual election, the corporation must furnish each stockholder with a copy of a financial statement.

Louisiana. Once every calendar year the corporation shall mail a statement of the last annual report to any stockholder requesting it.

Maryland. Corporations must keep on file in principal office in the state a copy of the annual report for the use of the stockholders.

Michigan. A true statement of accounts shall be exhibited to the stockholders at least once a year.

Minnesota. When required, corporations shall present to the stockholders written reports of the condition of the business.

Missouri. All books of the corporation shall be open to inspection by the stockholders.

Montana. Stockholders owning 5 per cent or more of the stock of a corporation must be furnished upon request with a complete statement of conditions.

New Hampshire. Stockholders have a right to examine records and accounts of importance.

North Dakota. A statement of accounts shall be laid before the stockholders annually.

New York. Corporations (except moneyed) must furnish a statement of affairs if requested by stockholders owning 5 per cent of the capital stock when not in excess of $100,000; or 3 per cent if in excess of $100,000. Corporations are not required to submit more than one such statement a year. A copy of any such statement must be kept on file in the office of the corporations for 12 months for the benefit of all stockholders.

Ohio. Corporations must furnish each stockholder with a copy of an annual statement of its financial condition.

Oklahoma. Once a year a statement of accounts shall be laid before the stockholders.

South Carolina and South Dakota. Books of account shall be open at all reasonable times to the inspection of the stockholders.

Wisconsin. At least once a year each corporation shall make and file in its principal office and keep on file there for the use of its stockholders a report of its financial condition.

Wyoming. Upon written request by any person or persons owning 15 per cent of the capital stock of the company, such company shall make to that person or persons a statement of affairs. A copy of such statement shall be held on file in the principal office for a period of 6 months.

Oregon. All books of the corporation necessary for carrying on its business shall be subject to the inspection, at all reasonable hours, of any stockholder applying therefor.

The following states have made no provision for:

1. Publishing of financial statements of corporations.
2. Rendering of such financial statements to state officials.
3. Inspection of records and books of account by creditors or stockholders.
4. Submitting of financial statements to stockholders.

Alabama	Indiana
Connecticut	Iowa
Delaware	Kentucky
Florida	Maine
Georgia	Mississippi
Idaho	New Jersey
Illinois	New Mexico

North Carolina
Rhode Island
Texas
Utah
Virginia
Washington
West Virginia
Philippine Islands

False Statement Legislation—Federal Law

A false statement may be defined as one which, by overestimating the value of the assets, omitting liabilities, improperly classifying items, or in some other way conveys the impression that the financial condition of the enterprise is otherwise than it in reality is.

It should also be remembered in this connection that it is a crime to obtain money or property under false pretenses, or to use the mails to defraud.

Section 215, of the United States Criminal Code, provides:

> Whoever, having devised or intending to devise any scheme or article to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, etc., shall for the purpose of executing such schemes or artifice, or attempting so to do, place, or cause to be placed, any letter, postal card, package, writing, circular, pamphlet, or advertisement, whether addressed to any person residing within or outside the United States, in any post-office, or station thereof, or street or other letter box of the United States, or authorized depository for mail matter, to be sent or delivered by the Post Office establishment of the United States, or shall take or receive any such therefrom, whether mailed within or without the United States, or shall knowingly cause to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such letter, postal card, package, writing, circular, pamphlet, or advertisement, shall be fined not more than one thousand dollars, or imprisoned not more than five years, or both.

Consequently, all the envelopes in which the financial statements are received should be carefully preserved after having been dated and signed by the one who received the statement and by a responsible witness; for if a statement is

proved in any later development to have been purposely made false, the party is legally liable for obtaining goods under false pretenses, since the acknowleged purpose of such a report, it is always understood, is to afford a basis for the extension of credit and this precaution will prove of great value in offering competent testimony that the mail was used to defraud.

A rubber stamp is sometimes used for this purpose which reproduces the following phrase:

> This envelope received the........day of..........192—
> contained the financial statement of.....................
> for ....
> Witnessed:
>
> Signed:

The envelope should then be permanently attached to the statement itself. When thus preserved such evidence is admissible in the prosecution of a case of fraud.

State Laws

It is to be noted that the above-quoted law covers only one particular class of cases in which a false financial statement has been sent through the mail service. The next step taken was made necessary by the rapid development and increased use of financial statements as a basis of credit, and its purpose was to safeguard creditors against those who would issue a false statement to secure credit.

The general purpose of a false statement law is explained in its title, and the model false statement law is broad enough in scope to cover all cases of the making of false written statements to procure credit in any form, and whether made direct to the creditor or indirectly through the mercantile agencies. Moreover, it aims at the person who makes the statement or causes it to be made, whether such person seeks the credit for himself or for any other person, firm or corporation.

Some form of special statute has been enacted in 32 states providing for the punishment of this class of offenders, when the offense is committed in such a way as not to come within

the jurisdiction of the federal authorities, and these laws act as a strong deterrent force against those who might otherwise be tempted to make false statements.

The New York law, enacted in 1912, is considered the model false statement law. In fact, it has been copied verbatim in a good many other states. It makes the provision that any person:

> 1. Who shall knowingly make or cause to be made, either directly or indirectly, or through any agency whatsoever, any false statement in writing, with intent that it shall be relied upon, respecting the financial condition, or means or ability to pay, of himself, or any other person, firm or corporation, in whom he is interested, or for whom he is acting, for the purpose of procuring in any form whatsoever, either the delivery of personal property, the payment of cash, the making of a loan or credit, the extension of a credit, the discount of an account receivable, or the making, acceptance, discount, sale or indorsement of a bill of exchange, or promissory note, for the benefit of either himself or of such person, firm or corporation; or
>
> 2. Who, knowing that a false statement in writing has been made, respecting the financial condition or means or ability to pay, of himself, or such person, firm or corporation in which he is interested, or for whom he is acting, procures, upon the faith thereof, for the benefit either of himself, or of such person, firm or corporation, either or any of the things of benefit mentioned in subdivision one of this section; or
>
> 3. Who, knowing that a statement in writing has been made, respecting the financial condition or means or ability to pay of himself or such person, firm or corporation, in which he is interested, or for whom he is acting, represents on a later day, either orally or in writing, that such statement theretofore made, if then again made on said day, would be then true, when in fact, said statement if then made would be false, and procures upon the faith thereof, for the benefit either of himself or of such person, firm or corporation, either or any of the things of benefit mentioned in subdivision one of this section.
>
> Shall be guilty of misdemeanor and punishable by imprisonment for not more than one year or by a fine of not more than one thousand dollars, or both fine and imprisonment.

Where such a statute has been enacted, the only elements of proof required against the defendant are, according to the law, as follows:

> 1st: That he made a statement;
> 2d: That the statement is false;
> 3d: That he made it with the intention that it should be relied upon;
> 4th: That he made it for the purpose of securing credit in some form or other.
>
> It is clear that a statement may be *false* without being *fraudulent;* that is to say, it may be exaggerated without intention to defraud anyone. It may be untrue in fact, but it may be made with innocent intent. The merchant may intend to continue business and pay for the goods. The new statute, however, stops precisely this thing and makes it a misdemeanor to make a false statement, even without fraudulent intent. It is based upon the same principle that makes the carrying of a deadly weapon a crime. If the weapon is used to commit murder, the defendant is guilty of murder, but we no not wait until he commits murder if we find him possessed of a deadly weapon. The possession of instruments of crime is made a crime, so as to deter the commission of more serious crime. Hence, the making of a false statement, even though without fraudulent intent, is made a misdemeanor.

Several unsuccessful attempts have been made to have a national false statement law enacted which would apply to interstate credit transactions in the same way the state false statement laws of the states apply to intrastate credit transactions.

Section 215 of the Criminal Code would seem to be adequate to cover instances where the mail has been used to transmit a false statement for the purpose of procuring credit, but it is possible to conceive of instances which would not fall within its provisions or the provisions of the false statement law of some particular state, and yet give rise to a credit transaction of an interstate character; e.g., a merchant from New Jersey comes over to New York and personally submits a false statement on the strength of which merchandise of the

value of $1,000 is delivered to him in New Jersey. Assuming the fraud to have been committed in New York, the laws of New York have no exterritorial effect whereby a man can be prosecuted in New Jersey for a crime or misdemeanor committed in New York. But assuming a national false statement law to be in effect, such an offender could be prosecuted in the federal courts.

CHAPTER XV

COMPARATIVE STATEMENT ANALYSIS

Practical Value

The analysis of a merchant's financial affairs along the lines indicated in the preceding chapters gives the credit man a clear insight into the condition of the business at the time the statement was prepared, and when these analyses are compared year with year over an extended period, still further information is disclosed. This means that we should have some record, as between property statements of different dates, so as to be able to compare accurately and quickly the essential items shown on such statements. It is for this reason that efficient credit departments call for statements from their customers at frequent intervals, for the value of such comparative credit data in determining the trend of the business and to show whether it is improving, standing still, or retrograding, cannot be overestimated.

On the other hand, it is equally true that when analyzed only superficially, comparative statements may be very deceptive and misleading, and it is only when the analysis is properly carried out that they afford the very best source of information or index as to the trend of the business.

Use of Comparative Statements

In comparative analysis an increase in the net worth as between any two years creates a feeling of security in the mind of the credit man, but in comparing financial statements it is necessary to note not only the change in net worth, but also the change in the specific items, because it is entirely possible for the net worth to show a steady increase without necessarily

signifying a betterment in the concern's financial condition, from the point of view of the credit man; i.e., the increment may be due entirely to an increase in value of the fixed assets.

The point can be made clear by means of a simple illustration:

1921

Quick Assets	$30,000.00	Quick Liabilities	$15,000.00
Fixed Assets	15,000.00	Fixed Liabilities	8,000.00
	$45,000.00		$23,000.00
Working Capital	$15,000.00		
Net Worth	22,000.00		

1922

Quick Assets	$25,000.00	Quick Liabilities	$15,000.00
Fixed Assets	30,000.00	Fixed Liabilities	8,000.00
	$55,000.00		$23,000.00
Working Capital	$10,000.00		
Net Worth	32,000.00		

The net worth is larger in 1922 by $10,000 but the business is in a worse condition in so far as the extension of credit is concerned, because of the decrease in working capital.

Proper Index

As a rule if the business is improving, the the ratio between the quick assets and the quick liabilities should show an increase; and conversely, if the ratio is decreasing (even though the actual amount of the quick assets over the quick liabilities is increasing) the credit situation is becoming weaker.

To simplify the illustration of this point, let us first assume that there are no fixed assets or fixed liabilities to be taken into consideration in connection with the following statements:

December 31, 1920	Surplus of $	200	over liabilities of $	200
" 31, 1921	" "	400	" " "	600
" 31, 1922	" "	1,000	" " "	9,000

1920 Statement

Quick Assets............. $400.00 Quick Liabilities.......... $200.00

Excess of quick assets over quick liabilities = $200

Ratio = 2 : 1

1921 Statement

Quick Assets.......... $1,000.00 Quick Liabilities......... $600.00

Excess of quick assets over quick liabilities = $400

Ratio = 5 : 3

1922 Statement

Quick Assets........ $10,000.00 Quick Liabilities........ $9,000.00

Excess of quick assets over quick liabilities = $1,000

Ratio = 10 : 9

In order to test the "credit strength" of the business during these three years respectively, let us further assume the business to be a partnership and that one of the partners dies, necessitating a dissolution of the partnership and a sacrifice of the assets on a declining market, which nets but 50 per cent of the listed valuation:

In	1920	there	will	be	$200	to	pay	liabilities	amounting	to	$200
"	1921	"	"	"	500	"	"	"	"	"	600
"	1922	"	"	"	5,000	"	"	"	"	"	9,000

In other words, if your account with the partnership amounted to $100 at the time of the dissolution, you would recover the full amount in 1920. In 1921 your loss would amount to $40, and in 1922 you would receive but $10 and suffer a loss of $90.

The conclusion to be drawn from this illustration is that where the excess of quick assets over quick liabilities is larger but the ratio between them is smaller, the credit strength of the business, or the extent to which the line of credit extended is protected, is weakened.

This does not necessarily mean that under such circumstances the credit capacity of the business, or the *amount* of the working capital, is not greater; or that this partnership would not be entitled to a larger line of credit in 1921 than in 1920, or in 1922 than in 1921; but what it does mean is that the credit extended would not be so well protected or secured. In other words, while the credit capacity of the business would be greater, the credit strength would be weaker.

So the vital issue in comparing financial statements covering different years of business is to find out whether the relation or ratio between the quick assets and quick liabilities has increased or diminished. This comparison should be made each year so that fluctuations in the ratio can measure the degree of increase or decrease in the strength of the risk.

Compilation of the Statement

As a matter of office routine, the preliminary compilation of the record in comparative form can very readily be prepared by some subordinate in the department, thereby saving the time of the credit executive. The common practice in preparing a comparative statement for analysis is to use some standard form in which the succeeding statements may be set off, one against the other, in such a way as clearly to indicate the variations.

The form of comparative statement shown in Form 9, taken from Alexander Wall's "Analytical Credits," is well designed to carry out the method which has just been described.

Relation of Net Income to Capital Stock

While the net worth is misleading when used as an index in the analysis of non-corporate reports, there is a corresponding index that is frequently used in the analysis of corporate statements which is equally misleading and fallacious unless one understands precisely what it represents and is aware of the danger involved when it is improperly applied.

Perhaps the most commonly used index as to the progress a corporation is making in the conduct of the business is the ratio existing between the net income and the capital stock, and while reliable inferences may be made under certain conditions from the fluctuations in this ratio, it is misleading when used as an index unless one understands precisely what it represents and the purpose for which it may be properly used.

COMPARISON OF STATEMENTS

ASSETS					
Cash on Hand and in Bank,					
Bills Receivable, all good, on hand,					
Bills and Acc'ts Rec. due from Off'rs or St'kholders,					
Accounts Receivable, all good, due from customers,					
Merchandise, finished,					
Merchandise, unfinished,					
Raw Material,					
TOTAL QUICK ASSETS					
Real Estate,					
Buildings,					
Machinery and Tools,					
Furniture and Fixtures,					
Prepaid Insurance,					
TOTAL NON-CURRENT ASSETS,					
TOTAL,					
LIABILITIES					
Bills Payable for Merchandise,					
Bills Payable negotiated to Banks,					
Bills Payable otherwise disposed of,					
Bills and Acc'ts Pay. due Off'rs or Stockholders,					
Open Accounts, not due,					
Open Accounts, past due,					
Deposits of Money,					
Interest Accrued,					
Pay Roll and Salaries Accrued,					
Reserved for Taxes,					
TOTAL QUICK LIABILITIES,					
Liens or Mortgages on Real Estate,					
Bonded Debt,					
TOTAL LIABILITIES,					
Reserves,					
Capital,					
Surplus, including undivided profits,					
Net Worth,					
TOTAL,					
Total Quick Assets,					
Total Quick Liabilities,					
Excess Quick,					
Deduct Reserves Against Current Assets,					
Net Excess Quick,					
Ratio,					
Sales,					
Net Profits Last Year's Business,					
Dividends or Withdrawals,					
Insurance on Merchandise,					
Insurance on Real Estate,					
Contingent Liability,					
Outside Worth of Sureties,					

Form 9. Comparative Statement

Improper Use

Several years ago, in order to point out the fallacy involved in a statement which was being given wide publicity, to the effect that the four largest packing companies were earning over 25 per cent on their capitalization, a very interesting and enlightening analysis of the situation was made with a view to showing how misleading, although true, the statement actually was.

As a first step the analyst tabulated the capital stock, surplus, reserves, bonded debt, and current liabilities of each of the four companies, in order to show the great variance that existed in the manner and means of financing these corporations. The findings are shown on page 185.

From this table it will be noted that, whereas Armour and Morris financed their business principally through the issue of bonds, the principal source of capital used in the business of Cudahy and Swift was derived from the sale of stock.

As a second step in the analysis, the ratio of the net income to the capital stock in each of these companies was calculated, showing that whereas the total earnings of all four companies averaged 25 per cent of the capital stock, it was considerably less than that in the case of the two companies which had comparatively large bond issues outstanding, namely, Armour and Morris. The percentage for each of the companies was as follows:

	Armour & Co.	Cudahy Pkg. Co.	Morris & Co.	Swift & Co.
Ratio of net income to capital stock.....	55.0	6.03	77.3	18.8

Average for all 4 companies = 25.65%

(When the financial writer made his calculation he added the earnings of all the companies together and divided by the aggregate of the actual issues.)

Ratio of Net Income to Total Invested Assets

Having thus demonstrated how fallacious and misleading the general statement referred to actually was, the next step

	Armour & Co.		Cudahy Pkg. Co.		Morris & Co.		Swift & Co.	
Capital Stock	$ 20,000,000	9.93%	$12,000,000	30.92%	$ 3,000,000	5.10%	$ 75,000,000	36.17%
Surplus	98,733,117	49.05	6,050,270	15.59	29,510,270	50.14	45,850,000	22.11
Reserves	....	....	....	....	4,597,356	7.82	5,900,884	2.85
Total Owned Capital	$118,733,117	58.98%	$18,050,270	46.51%	$37,107,626	63.06%	$126,750,884	61.13%
Bonds	$ 30,000,000	14.90%	$ 3,519,000	9.07%	$11,300,000	19.20%	$ 24,500,000	11.81%
Current Liabilities	52,583,248	26.12	17,237,518	44.42	10,438,963	17.74	56,115,556	27.06
Total Borrowed Capital	$ 82,583,248	41.02%	$20,756,518	53.49%	$21,738,963	36.94%	$ 80,615,556	38.87%
Total Combined Capital	$201,316,365	100.00%	$38,806,788	100.00%	$58,846,589	100.00%	$207,366,440	100.00%

was to establish the proper basis for estimating or measuring business earnings. This he did, by calling attention to the fact that the capital stock of a corporation alone does not represent the total invested assets of a business, and that the total capital fund employed in the business must be used as the basis for computing the percentage return of the business. In other words, capital, as distinguished from capital stock, consists of all the property owned by the corporation, without regard to whether it was contributed by the stockholders or not.[1]

In the case of these four companies, when the ratio of net income to the total invested assets was used as the basis of comparison, it showed the following:

	Armour & Co.	Cudahy Pkg. Co.	Morris & Co.	Swift & Co.
Ratio of net income to total assets......	5.46	1.86	3.94	6.83

Average for all 4 companies = 5.57%

Internal Analysis—Other Ratios

In the preceding sections the more or less general method of comparative statement analysis was discussed, which consists in putting into comparative relationship the current assets and liabilities of successive years. But the tendency of this kind of analysis has been to stimulate comparisons in bulk rather than comparisons of proportions, and it has been contended that reliance upon such ratios alone is unscientific.

However, the fact that such a proportional study method is vindicated by the extent to which the current ratio has been adopted gives rise to the probability of other proportional comparisons being also of value, and it was with this thought in mind that Alexander Wall, in his treatise on "Analytical Credits," has made a most interesting and comprehensive analysis of numerous other ratios, which are as follows:

1. Ratio of Receivables to Merchandise.

This ratio is found by adding the accounts and bills

[1] See Greendlinger, Financial Statements, p. 226.

receivable and dividing by the total of the merchandise inventory.

2. Ratio of Debt to Net Worth.
   This ratio is found by dividing the total debt, both current and funded, by the total net worth.
3. Ratio of Net Worth to Non-Current Assets.
   This ratio is found by dividing the net worth by the total of the non-current or fixed assets.
4. Ratio of Sales to Receivables.
   This ratio is found by dividing the total sales by the total receivables.
5. Ratio of Sales to Merchandise.
   This ratio is found by dividing the total sales by the merchandise inventory.
6. Ratio of Sales to Net Worth.
   This ratio is found by dividing the total sales by the net worth.
7. Ratio of Sales to Non-Current Assets.
   This ratio is found by dividing the total sales by the non-current assets.

Window Dressing

Mr. Wall properly calls attention to the fact that the real fundamental value of a study of the current ratio lies not so much in the development of the percentage at which the current ratio rests as in a study of the direction in which the current ratio is moving. By this he simply means that an increasing current ratio may normally be expected to accompany an improving condition, and that a receding current ratio may normally be expected to accompany a weakening credit condition.

One argument in favor of resorting to other comparisons in the analysis of the statement is the fact that the knowledge on the part of credit-seekers that their statements are to be tested by the current ratio has led to the "doctoring" of statements. This is not difficult and can be successfully accom-

plished by any one of several processes. For illustration, suppose a statement shows the actual status of the business to be as follows:

Current Assets............. $1,500 Current Liabilities.......... $1,000
Ratio = $1\frac{1}{2}$: 1

The merchant, realizing that this ratio will not satisfy the required standard of 2 to 1, proceeds to liquidate some of his current assets, either by forcing a sale of part of his merchandise, or possibly by forcing payment of part of his receivables, and with the proceeds thus obtained reduces his current liabilities. Let us assume that he succeeds in liquidating his current assets $500. His statement would then read as follows:

Current Assets............. $1,000 Current Liabilities........... $500
Ratio = 2 : 1

The explanation of this change in the ratio lies in the fact that an addition of an equal amount to both the current assets and the current liabilities has the effect of changing the proportional relation, or ratio. In other words, an increase of both the current assets and current liabilities can only keep the ratio at the same point if it is in the same proportion as expressed by the ratio. This process of doctoring is commonly referred to as "window dressing."

Other Ratios Explained

The other ratios developed by Mr. Wall tend to disclose the proportions existing between actual component parts of the statement, the theory being that the fluctuation of these items and their proportions to each other afford an index as to the actual condition of the business. Following is an explanation of these ratios:

1. Ratio of Receivables to Merchandise. It has become proper practice to show merchandise on statements either at cost or at present market value if the present market value

has fallen below the cost price, in order that no anticipatory profit shall appear in this item.

The item of receivables, however, represents the cost of the merchandise plus the profit to be derived from the sale.

Therefore, according to Mr. Wall, if we have a statement primarily merchandise as to its current assets, and later a statement primarily receivables as to its current assets, the change ought to be accompanied by a rise in the current ratio. If this is not the case, then the management of the business has added something in the nature of current debt which should be investigated with a view to determining just why such negative operation was necessary.

2. DEBT TO NET WORTH. Ordinarily, the economic capital used in a business is derived from two sources: (1) the portion advanced by the owners, and (2) the portion advanced by the creditors. Once intermingled, an exact division of the assets purchased by each becomes practically impossible; but it is possible at any time to ascertain the proportion that exists between the owned and the borrowed capital. If, for example, the total debt of the business is equivalent to the net worth, it follows that 50 per cent of the assets are secured from funds belonging to the creditors.

Quick Assets	$ 600	Quick Liabilities	$300
Fixed Assets	600	Fixed Liabilities	300
	$1,200	Total Debt	$600
		Net Worth	$600

The inference to be drawn from fluctuations in this ratio is that if in successive years the percentage of debt to the net worth is found to be increasing, the business is relying to a greater and greater extent for its economic capital upon the good-will of its creditors. As the debt ratio rises, the moral risk becomes more important, because any loss of faith in the future of the business would affect a larger part of the capital used in the business.

When a large ratio of debt to net worth is shown, but a considerable portion of the debt is funded, it is advisable to establish a current debt to net worth ratio to see if this ratio is reasonably low. For example, if a 50 per cent ratio of debt to net worth seems reasonable and the statement discloses a 75 per cent ratio, the ratio of current debt to net worth should be less than 50 per cent, because when a proportion of the debt is funded, the necessity for current indebtedness is thereby materially reduced. Under such circumstances, it is the opinion of Mr. Wall, a safe current debt to net worth ratio ought not to exceed approximately 30 per cent, and approximately 45 per cent of the total debt to net worth should be in funded debt.

3. Net Worth to Non-Current Assets. It is not, as a rule, considered good business judgment to have non-current assets represented by that part of the whole capital which has been supplied by the creditors, except as may be provided under certain circumstances by funded debt.

By establishing a proportional comparison between the net worth and non-current assets, it is possible to determine what proportion of the owner-controlled funds or capital remains available, after the non-current assets have been financed, for the current operating features of the business.[2]

If it is found that there has been an increase in net worth but that the ratio of net worth to non-current assets has declined, the logical inference would be that the owners of the business have expanded their plant more rapidly than is justified by the normal growth of the business. It is not difficult to fancy the embarrassment which might ensue from such a condition in a period of business depression.

4. Sales to Receivables. Assuming that the 2 to 1 current ratio standard is being used, there is little doubt but that any creditor would be willing to extend or continue a line of credit in spite of a lower current ratio if he could be as-

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[2] Under the Federal Reserve Act only such paper is eligible for rediscount as has been used to produce funds for commercial purposes.

sured as to the "freshness" of the receivables. The question then develops as to how the character of the receivables may be analyzed with reasonable certainty.

If a series of successive statements discloses that the bulk of the receivables is increasing, but that the volume of sales is also increasing with sufficient rapidity to increase the ratio of sales to receivables, it can reasonably be inferred that the business is not accumulating old receivables. If, however, an increasing volume of sales but a decreasing ratio as between the sales and receivables is found, the inference is that there is a greater proportion of the receivables past due. In other words, the liquidity of the receivables can be measured by keeping a record from year to year of the ratio that exists between the sales and the receivables.

5. Sales to Merchandise. If the comparison of statements from year to year discloses an increasing inventory, it should tend to suggest that the business may be working into an overinventoried condition. But if a further analysis discloses that the volume of sales is also increasing in sufficient amount to increase the ratio of sales to merchandise, this fact would serve to rebut any such presumption, because the inventory, while larger, is being consumed more rapidly.

6. Sales to Net Worth. True business efficiency is predicated upon the activity of the invested capital and this can be measured to a very great extent by the relationship of the sales to the net worth. In other words, assuming a fixed margin of profit, the greater the volume of sales, the greater will be the profits on a fixed capital or net worth investment. Consequently, if a ratio of sales to net worth is established, the activity of the owner's invested capital can be ascertained. If this ratio is an increasing ratio, the activity of these funds is greater, and with the same margin of profit, the earnings should be greater.

As Mr. Wall states, an old-established business lacking progressive management may not keep its funds actively em-

ployed. This inactivity may be sufficient to run the business into what has been termed a condition of "dry rot." This condition is often indicated by a continual yearly falling off in the ratio that exists between the sales and the net worth.

7. Sales to Non-Current Assets. The purpose of establishing this ratio is to determine whether or not the productivity of the fixed assets is increasing or decreasing, and if such a relationship is established and then reduced to a percentage basis by multiplying the resultant by 100, it affords an index showing the dollars of sales for every dollar invested in non-current assets.

The following comparative statement is taken to show the extent to which the intrinsic value of an apparently good risk may be modified by changes during the two preceding years:

Assets

	1920	1921	1922
Capital Assets:			
Land and Buildings	$ 75,000.00	$ 75,000.00	$ 75,000.00
Machinery and Equipment	22,540.00	22,640.00	24,110.00
Furniture and Fixtures	6,425.00	6,655.00	7,196.00
Total	$103,965.00	$104,295.00	$106,306.00
Current Assets:			
Merchandise	$ 42,226.16	$ 49,869.42	$ 48,646.62
Cash	19,212.73	11,164.13	6,162.50
Accounts Receivable	21,323.14	28,266.62	24,121.06
Notes Receivable	8,429.22	7,010.71	7,071.13
Total	$ 91,191.25	$ 96,310.88	$ 86,001.31
Total Assets	$195,156.25	$200,605.88	$192,307.31

Liabilities

	1920	1921	1922
Capital Liabilities:			
Capital Stock	$ 85,000.00	$ 85,000.00	$ 85,000.00
Mortgage on Plant	40,000.00	40,000.00	40,000.00
Total	$125,000.00	$125,000.00	$125,000.00
Current Liabilities:			
Accounts Payable	$ 7,103.15	$ 13,264.24	$ 18,002.65
Notes Payable	6,000.00	16,500.00	18,500.00
Total	$ 13,103.15	$ 29,764.24	$ 36,502.65

Liabilities

	1920	1921	1922
Reserves:			
Depreciation of Buildings.....	$ 9,160.00	$ 11,748.00	$ 12,486.00
Depreciation of Equipment....	7,323.00	8,781.00	10,052.00
Depreciation of Fixtures......	1,451.00	1,610.00	2,228.00
Total....................	$ 17,934.00	$ 22,139.00	$ 24,766.00
Surplus......................	$ 39,119.10	$ 23,702.64	$ 6,058.66
Total Liabilities..........	$195,156.25	$200,605.88	$192,357.31
Total Quick Assets.............	$ 91,191.25	$ 96,310.88	$ 86,001.31
Total Quick Liabilities..........	13,103.15	29,764.24	36,502.65
Working Capital.............	$ 78,088.10	$ 66,546.64	$ 49,498.66
Ratio........................	7 to 1	3 to 1	2 to 1
Sales........................	$140,165.36	$112,925.75	$105,544.04

This statement indicates a fairly strong financial condition in 1922, showing working capital amounting to $49,498.66, and a current ratio of a little better than 2 to 1. In other words, the company, in the absence of any other adverse information, would be entitled to a reasonable line of credit. But at the same time, when viewed in comparison with the statements of the preceding two years, it discloses a rather unsatisfactory condition, in view of the rapidly decreasing current ratio and the surplus account.

Furthermore, whereas the volume of sales amounted to some $35,000 less in 1922 than in 1920, the amount of the receivables, instead of showing a corresponding decrease, show an increase of approximately $15,000.

CHAPTER XVI

SIGNIFICANCE OF WORKING CAPITAL

Science of Working Capital

No business handicapped by a shortage of working capital can function as efficiently as one with a sufficient working capital at its disposal. There are times when a merchant can get along with a very limited amount of working capital in his business, and others when he needs three or four times as much to handle the same relative amount of business, or perhaps an even smaller volume of business. During periods of business prosperity when business is booming, so to speak, it requires no special ability on the part of the average merchant to do a good volume of business, owing largely to the favorable conditions that exist for financing his business. For example, if he is doing at such a time a volume of business that would require a working capital of $75,000, he probably could borrow $60,000 from the bank on the strength of it without any trouble, and with small risk of being called upon to repay it at a time when it would not be convenient or possible without suffering a loss.

If, however, instead of being able to convert his goods into money rapidly, he is confronted with the opposite situation, where the goods are accumulating and his volume of business has for some reason contracted, the amount of working capital that he needs is greater than before and his ability to get it is correspondingly reduced, owing to the less favorable capital conditions that exist at such times.

It has been truthfully said that the failure of merchants to understand the science of working capital in their business under different business conditions constitutes one of the prin-

cipal reasons for business failures. And it is also true that the failure on the part of the credit man of a business to understand the science of working capital under different kinds of business conditions has resulted in serious losses which might otherwise have been avoided.

The Business Cycle

Business conditions are never constant and commerce is constantly vacillating between alternate periods of dullness and of prosperity, or, as we shall hereafter refer to them, "liquidation periods" and "buying movements." This is what is meant when it is said that business moves in well-defined cycles, each of which consists of two parts or phases, a buying period and a liquidation period. In other words, periods of business prosperity are invariably followed by periods of business depression, and vice versa. Numerous reasons and causes are given for this, but perhaps the most important is the maladjustment of production to the changed relation of supply and demand, and the exhaustion of available credit.

During a liquidation period a very important consideration in connection with the factor of working capital is keeping the working capital in as liquid a form as possible. The reasons for this are quite obvious. If the working capital is kept very liquid it is available for debt-paying as obligations fall due. Furthermore, it does not depreciate in value much, if at all. Whereas if it is being carried in the form of merchandise and the value of the merchandise declines, it does depreciate.

Credit Phase

However, it is the credit phase of this economic transition that is of importance to the credit man; in other words, in what way and to what extent does this change from buying periods into periods of liquidation affect the credit capacity or debt-paying power of his customers? In the first place, high commodity prices must go hand in hand during the up scale

or buying movement of the cycle, with a decrease of business failures. The reason is plain enough. As prices and values of commoditites advance, merchants are prosperous, their investments of capital increase in value, and their profits increase—they make money. Consequently, the rate of business mortality declines.

On the other hand, just as that credit-strengthening movement is true and characteristic of the up scale or buying period of the cycle, so it is equally true that during the liquidation period of the cycle, as commodity prices become deflated, the number of business failures increases. Consequently, the responsibility involved in handling the credit risks in connection with the sales end of a business during a liquidation or deflationary period constitutes a very important part of a credit man's work. He is practically free from anxiety during the up scale of such a general cycle, but he is confronted with a serious problem during the down scale.

Proper Handling of Working Capital

It is not difficult to illustrate the importance of the cash capital factor in a business during a liquidation period. It can be done by means of two simple illustrations, showing the natural trend in the changes that take place in the assets constituting the working capital of a business during a liquidation period, first, in the business of a merchant who does not understand the science of working capital, and therefore does not properly prepare for the liquidation period, and then in the business of another merchant doing business under precisely the same conditions, but who does understand the natural changes that take place during a liquidation period, and makes the necessary preparations to "weather the storm" without incurring any unnecessary and avoidable losses.

Both of these illustrations start with the financial status of a business at the end of a period of business prosperity and at a time when orders were being received in heavy volume and

the production facilities were being taxed to the utmost to satisfy the existing demand for the product. The fixed asset items have not been included for the reason that they undergo comparatively little change in value or depreciation during the revolution of the business cycle.

Let us assume that the first merchant, having increased his volume of business considerably, has determined to maintain that volume as his future standard regardless of changes in general business conditions, and that, instead of regulating his volume of production to meet the changing demand for his goods, he regulates the demand for his product through the sale price of his goods. His current assets, cost of production, and new orders, or new business at the beginning of a 6 months' period and at the end of each of the 6 months were as follows:

	Start	End of 1st Mo.	End of 2nd Mo.	End of 3rd Mo.	End of 4th Mo.	End of 5th Mo.	End of 6th Mo.
Merchandise:							
Finished Goods	$13,000	$15,000	$18,000	$22,000	$26,000	$30,000	$32,000
Goods in Process	7,500	7,500	7,500	7,000	6,000	5,000	4,000
Raw Materials	10,000	9,500	9,500	9,000	8,000	7,500	7,000
Accounts Receivable	9,000	9,000	8,500	7,500	7,000	6,000	5,500
Notes Receivable	3,500	3,000	2,500	2,000	1,500	1,000	500
Cash	7,000	6,000	4,000	2,500	1,500	500	....
Quick Assets	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000
Cost of Production	$15,000	$15,000	$15,000	$13,000	$12,000	$11,000	$ 8,000
New Orders	15,000	13,000	12,000	9,000	8,000	7,000	6,000
Increase of Stock	....	$ 2,000	$ 3,000	$ 4,000	$4,000	$ 4,000	$ 2,000

Buying inactivity on the part of the consuming public is one of the characteristic features of a depressed business condition, and there are times when even radical price reductions do not suffice to stimulate buying. So it has been assumed that in spite of all the efforts made by the merchant to maintain his chosen volume of business, the new orders decline in volume month by month from $15,000 the first month to $6,000 at the

end of the 6 months' period, which is not a greatly exaggerated change in volume during extreme liquidation periods.

During the first month the merchant was able to keep his production running at the rate of $15,000 a month, although there was a decline in the volume of new orders from $15,000 to $13,000, or of $2,000, which was added to the completed stock. This $2,000, which was converted into finished goods during the month, increased the completed stock on hand from $13,000 to $15,000. The amount of working capital in the business remaining constant, this means that a reduction of $2,000 must be made in the other quick assets, and it has been assumed that in addition to the $500 converted raw material which was not supplanted, $500 of the notes receivable and $1,000 of the cash on hand was used. In other words, the $2,000, comprising $1,000 cash, $500 notes receivable, and $500 raw material, was converted into finished stock on hand during the first month of this liquidation period.

In the second month, the new business fell off another $1,000, whereas the production cost of $15,000 was still maintained, and it will be noted that the finished goods on hand increased from $15,000 to $18,000. Of this $3,000, $1,000, it will be assumed, was drawn from the accounts and notes receivable, and the remaining $2,000 from the available cash.

At the end of the third month we find that the new business has dropped off $3,000, and in view of the rapidly accumulating stock on hand, which now amounted to $22,000, it is assumed that the production costs were curtailed $2,000. It will be noted that the additional $4,000 worth of finished goods resulted in a further reduction being made in the other assets, which reduction is assumed to have comprised $500 of goods in process, $500 of raw materials, $1,000 of accounts receivable, $500 of notes receivable, and $1,500 of cash.

By the end of the fourth month it was absolutely necessary to curtail further the production cost $1,000 and the volume of orders received diminished from $9,000 to $8,000,

necessitating the carrying in stock of an additional $4,000 worth of finished goods, which, it is assumed, was taken out of the other assets as follows: goods in process $1,000, raw materials $1,000, accounts receivable $500, notes receivable $500, and cash $1,000.

Gradually we find the merchant's credit position becoming weaker and weaker in spite of the increased curtailment in the cost of production, until at the end of the fifth month of this liquidation period the finished goods was more than doubled in amount and the cash capital was reduced from $7,000 to $500.

By the end of the sixth month (liquidation periods sometimes last from 12 to 18 months) the merchant would be compelled to discontinue business (assuming he lasted that long) unless he was in a position to obtain additional funds from outside sources with which to continue the business.

So we find that instead of successfully carrying out his intention to maintain a uniform cost of production of $15,000 a month he was not only compelled to cut it in half within 6 months' time, but that by that time his financial strength had diminished to such an extent as to compel him to discontinue business. The business was no longer able to maintain its organization, simply because the merchant did not understand the science of working capital in the conduct of his business.

His conclusion that a working capital of $50,000 was sufficient to finance a business of $15,000 a month at all times, regardless of changing business conditions, was unsound. It was sufficient, and no doubt more than sufficient, to finance his business during the preceding buying movement, because a business does not require much cash capital at such times. The tendency then is for the stock on hand to diminish rather than increase. So then it becomes obvious that the cause of the merchant's downfall was his failure to realize the economic fact that more working capital is required in a business at one time than at another.

Improper Handling of Working Capital

In the second illustration we will assume that the merchant, operating under precisely similar business conditions as in the first, is one who does understand the science of working capital, and see what preparation may be made and precautions taken to avoid the incurrence of such unnecessary losses. By "similar business conditions" is meant that the same volume of orders was received and the accounts and notes receivable were being realized upon from month to month at the same rate.

But instead of trying to adhere to and carry out some predetermined plan whereby the cost of production was to remain fixed at some arbitrary figure, it is assumed that this second merchant realizes the necessity of curtailing his production at the very beginning of a liquidation period. Of course, his sole object is so to manage his finances as to be, if possible, in a stronger instead of weaker position financially at the end of the liquidation period, and thus in a better position to take advantage of the increased volume of business offered when the next buying movement sets in. His quick assets, cost of production, and new orders change over the six months' period, as follows:

	Start	End of 1st Mo.	End of 2nd Mo.	End of 3rd Mo.	End of 4th Mo.	End of 5th Mo.	End of 6th Mo.
Merchandise:							
Finished Goods.....	$13,000	$13,000	$14,000	$16,000	$18,000	$20,000	$23,000
Goods in Process...	7,500	7,000	7,000	6,000	5,000	5,000	4,500
Raw Materials.....	10,000	9,000	8,500	8,000	7,500	7,000	6,500
Accounts Receivable..	9,000	9,000	8,500	7,500	7,000	6,500	5,500
Notes Receivable.....	3,500	3,500	2,500	2,000	1,500	1,000	500
Cash...............	7,000	8,500	9,500	10,500	11,000	10,500	10,000
Quick Assets.......	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000
Cost of Production....	$15,000	$13,000	$13,000	$11,000	$10,000	$ 9,000	$ 9,000
New Orders.........	15,000	13,000	12,000	9,000	8,000	7,000	6,000
Increase of Stock....	....	....	$ 1,000	$ 2,000	$ 2,000	$ 2,000	$ 3,000

During the first month it will be noted that the merchant decreased his production from $15,000 to $13,000, which, it so happened, was just sufficient to offset the decline in new business received. The effect of this decrease in production on the assets, it is assumed, was to decrease the amount of goods in process and the raw materials (the tendency under such circumstances would be to exhaust the supply on hand) to the extent of $1,500, which was added to the cash on hand.

In the second month the same cost of production was maintained, whereas the new business fell off another $1,000. It will be noted that as a result of this the finished goods increased in amount from $13,000 to $14,000, which was offset by the $500 reduction in raw materials item and an equivalent reduction in the accounts receivable. The notes receivable were also reduced $1,000 which, as a matter of course, increased the cash on hand from $8,500 to $9,500.

At the end of the third month we find that in spite of the fact that the merchant made a further reduction in his cost of production from $13,000 to $11,000, the overproduction for the month amounted to $2,000, due to the sharp decrease of $3,000 in the volume of new business received. This $2,000 overproduction increased the finished goods from $14,000 to $16,000, but owing to a further reduction being made in the outstandings, it will be noted that his cash capital increased another $1,000.

By the end of the fourth month he had curtailed his production another $1,000, and the volume of orders received also diminished $1,000, increasing the amount of his finished goods from $16,000 to $18,000.

And so on until after the merchant has passed through another two months of similar readjustment, we find his credit position becoming stronger and stronger irrespective of the decided falling off in his volume of business from $15,000 to $6,000 a month.

The important point to be noted in this connection is that

regardless of the steady decrease made by the merchant in his production, it was insufficient to offset the constant decline in new business received, as a consequence of which the amount of his finished goods was steadily increasing, until at the end of the 6 months' period he had accumulated some $23,000 finished stock on hand ready to throw on the market just as soon as the buying movement set in. However, as a result of curtailing his production he was able to increase his available cash from $7,000 to $10,000, thereby placing himself in a relatively stronger financial condition at the end of the 6 months than he was at the beginning.

With proper records and information before him, the efficient credit man should be able to determine where the responsibility for the financial condition of a business rests. Here, as we have seen, we have two merchants doing the same volume of business under precisely the same business conditions; but whereas one merchant was forced into a hopelessly inefficient condition by the end of the 6 months' period of liquidation, another merchant actually succeeded in increasing his cash capital from $7,000 to $10,000, and consequently was in a stronger financial condition at the end of the same 6 months' period.

The significance of this to a credit man is that such simple yet enlightening illustrations serve to indicate how important it is to scrutinize closely this very vital factor of working capital in a business, and particularly in analyzing financial statements on the eve of periods of business depression.

PART IV

INCIDENTAL FACTORS AFFECTING A CONCERN'S CREDIT STANDING

CHAPTER XVII

MANNER OF PAYMENT

Relation between Payments and Profits

Once an account is opened, other influences are brought to bear on a customer's credit standing which are of an entirely different nature from those which originally determined his financial or credit responsibility. For at first it is presumed that the applicant is deserving of a credit line of so much, and then it lies with him to prove himself worthy of it by strictly observing the terms of payment.

To obtain some conception of the significance which the manner of payment has on a concern's credit standing, and also of the importance of it in the successful management of a business, let us first consider the relation that exists between payments and profits.

It is a common if not the usual custom for merchants simply to deduct the purchase price or selling cost of a commodity from the sale price in order to measure their profit; i.e., they figure that if a certain commodity which costs them $100 is resold for $125, the profit on the sale amounts to $25. They assume that they have then arrived at a constant margin of profit, without considering another pertinent factor.

Suppose that a merchant makes two sales of a commodity for $125 each, which he purchased for $100, and that the first buyer paid cash, but the second buyer did not pay for 90 days. Is his profit on the two sales the same? Suppose he made 1,000 such sales a year to each of these merchants, would he derive the same net profit at the end of the year from both accounts?

This is precisely the situation that a merchant or manufacturer has to consider in marketing his goods. As a further illustration let us take the following three cases and see what the real significance of this factor actually amounts to:

1. A, a manufacturing concern, whose regular terms of payment are 30–1–10, sells B a bill of goods amounting to $500 on June 1, and B discounts the bill within the 10 days.

2. A similar sale is made to C, who pays promptly at maturity (July 1).

3. A third sale is made to D, who does not pay until 60 days after maturity (September 1), when A threatens to place the account in the hands of an attorney for collection.

Consider now the consequences resulting from such a variation in the manner of payment from two points of view:

1. As affecting the manufacturer's profit derived from the sale.
2. In molding his opinion of the purchaser as a credit risk.

Manufacturer's Profit as Affected by Time of Payment

In order to emphasize the point to be brought out, it will facilitate matters considerably to view the situation as of the time of D's payment—September 1. By that time A will have had the use of B's $495 ($500 less the 1 per cent discount) from June 10 to September 1, and assuming he is realizing an average rate of 20 per cent on his working capital, this will amount to $22 for the 80 days, so that he will then have realized $517 on the sale to B. Likewise he will have realized $16 on the use of the $500 received from C July 1, or $516.66 in all.

Before proceeding further it might be interesting to make a comparison between the profit derived from the sale to B, who discounts his bills, and the one to C, who pays promptly at maturity. In the former instance A receives $495 on the tenth day. The use of this money as a part of A's working capital for the next 20 days at 20 per cent nets him $5.55,

or a total of $500.55, as contrasted with the $500 received from C at maturity. In other words, the difference amounts to 55 cents a month on $500 worth of business, or, assuming B and C are handling A's product exclusively, and regularly purchase $500 worth of goods a month, the difference amounts to:

$ 6.60	on $	500	worth of business a year
13.20	"	1,000	" " " " "
132.00	"	10,000	" " " " "
1,320.00	"	100,000	" " " " "
13,200.00	"	1,000,000	" " " " "

On September 1, when A receives D's check for $500, he has realized $517 from his sale to B, $516.66 from his sale to C, and $500 from his sale to D, or approximately $17 difference between the sale to the one who discounts his bills and the one who pays promptly at maturity, and the third purchaser who takes 60 days' overtime. Extended, this amounts to a difference of:

$ 34	on a $	1,000	sale, 90-day payment
340	" "	10,000	" " " "
3,400	" "	100,000	" " " "
34,000	" "	1,000,000	" " " "

While the illustration used cannot be regarded as an extreme case, the result will serve to emphasize the fact that altogether too little importance is attached to the advantage and the profit derived from close collections. Particularly is this true since the increase in competition and corresponding decrease in the margin of profit in business today no longer permits long-time credits in domestic trade. The merchant in his function of creditor cannot afford to ignore so important a factor in his business, or to lose sight of the fact that there is no profit in a sale until the bill has been paid, and that, consequently, the longer the bill remains open after maturity, the smaller the profit will be.

Effect of Manner of Payment on Purchaser's Standing

On the other hand, it is equally true that altogether too little importance is attached by customers to the effect the manner in which they pay their bills has on their credit standing. That a premium is to be placed on the business of the man who discounts his bills, or pays promptly at maturity, is perfectly obvious from the foregoing. To just what extent this element should influence a credit man in estimating a credit risk may be ascertained by considering the following two examples:

> 1. Suppose you had a horse you wished to sell for $250 and the only man willing to give $250 for the animal offered his 60-day note in payment. The chances are greatly in favor of your accepting the note.
>
> 2. Suppose, however, there were two men willing to pay you $250 for the horse, one with a 60-day note and the other cash in 10 days. Then you would of course part with the horse to the latter.

The same principle of discrimination may be said to apply to business in general. If a concern could find sufficient customers willing and able to discount bills of sale covering their entire production, even the business of the man who pays promptly at maturity would be declined. On the other hand, if the output is sufficiently large (and it almost always is) to more than supply such cash customers, the business of the slower paying customers then, and then only, becomes attractive; or, couched in the phraseology of what may be termed a credit maxim, "the slower the pay, the less attractive the business," and, consequently, the larger the credit lines extended to those who pay their bills promptly.

Cost of Collection

There is still another very good reason for this. It costs money to carry slow accounts, in that it takes time on the part of the credit manager to formulate the policy for handling

nearly every collection and then to dictate the correspondence; time of the stenographer to write the collection letters; time of the file clerk in caring for them—to say nothing of the items of postage and stationery which, over a period of six months or a year, is no small item. The total cost constitutes a sum of sufficient size to justify giving serious consideration to the formulation of a definite policy in handling the accounts of the "slow-pay." A credit manager once said, when it was merely intimated what a joy it would be to be able to refuse to sell anyone on open terms who did not pay his bills promptly, "If I could be assured that we wouldn't lose any money by adopting such a policy, the very first thing I would do would be to cut down my office force from eight to three—a stenographer, an assistant, and myself."

Finally, with all due respect to the vigilance exercised by credit men in watching their accounts, the percentage of losses which can be attributed to carelessness is unjustifiably large. In other words, the high percentage of loss from bad debts in a firm's accounts may, as a rule, be attributed more to carelessness in following an account (such as failure to check over and revise the credit data frequently, delay in following up overdue accounts, and neglect in enforcing prompt collections) than to any lack of judgment in opening the account. Particularly is this true where a series of prompt payments has thrown a credit man off his guard and has caused him to regard what was originally considered a doubtful risk as a good account, and to allow an order to slip through here and there which eventually is entered in the loss ledger.

Such carelessness is oftentimes due to the credit man being so overwhelmed with detail work that he has insufficient time to devote to the study and consideration of the doubtful accounts—a fault of the system rather than of the man. The eradication of carelessness in such instances is to be accomplished by proper corrections and adjustment in the distribution or manner of handling the work. There are thus

sources of loss and error in credit work other than the judgment of the credit man, and the fact should never be overlooked that the avoidance of a loss is equivalent to making a profit. Consequently, the failure to avoid a loss is just as bad as the failure to make a profit. The net result is the same whether you break the eggs or whether you find they are not in your basket when you look for them.

Classification of Customers

For the purpose of identification it has been found convenient to classify customers according to the manner in which they pay their bills, as follows:

> Discount—only about 25 per cent of business concerns are said to discount their purchase bills all the time.
> Prompt-pay—pay promptly at maturity.
> Slow-pay—accustomed to taking overtime.
> Poor-pay—do not pay until they must.
> Cash, or sight draft—unworthy of credit for any amount.

1. The first class requires no explanation whatsoever. Suffice it to say that in the eyes of the credit men this class of customers constitutes the cream of the business world.

2. The second likewise requires little consideration. They need no watching and no prodding—merely an occasional check to see that no change has taken place in the manner of handling the account.

3. "Slow-payers," as Mr. Higginbotham, formerly credit manager of Marshall Field and Company, says, are especially troublesome. The credit man may know them to be perfectly good and safe, but because of carelessness, or because they are just chronically and habitually slow, they are forever letting their bills become overdue. The credit man must work with these men personally—educate and train them to proper business methods, even to the extent of coercion when friendly measures fail.

It should at all times be borne in mind by the collector

that persistence plays a most important part in the education of slow-paying customers to pay promptly, and, as we have seen, the relation which the prompt collection of accounts bears to the reduction of losses and increased profits cannot be overestimated; whereas the converse is also equally true, that a good account may easily be turned into a bad, or at least a doubtful one, by a little inattention at the proper time.

The constituents of this third class are quite numerous, varying in degree from the little slow, or those who meet their obligations with a fair degree of promptness (pay within 30 to 50 days), to the very slow, or those who delay payment as long as possible without being dragged into the law courts. Their business, however, may be said to be attractive to the average manufacturer, requiring only careful and constant attention. Moreover, salesmen will bear witness to the fact that that there is keen competition for the trade of the slow-pay, particularly those who are classed as "good but slow."

4. The class of customers constituting the fourth class, the poor-pay, consists of delinquent debtors, who for the most part are responsible but whom the merchant is generally obliged to sue in order to get his money. The accounts of such customers are bad assets, to say the least, for although the prospects are in favor of eventually collecting the account, it is going to cost money.

5. As to the last class, it is made up of merchants unworthy of credit, because of their lack of credit responsibility or other attributes essential to the extension of credit; or who have proved themselves members of that class of merchants ready and willing to abuse a line of credit in any way or manner possible. The business of this class is therefore undesirable on any basis other than cash in advance, or shipments made subject to a "sight draft drawn with bill of lading attached." To extend credit to such a class of customers is practically equivalent to buying a lawsuit.

CHAPTER XVIII

THE SECURING OF ACCOUNTS

Guaranty and Suretyship

A good credit man will try to fill every order that is received, and when conditions do not justify making shipment on open terms he will endeavor either to obtain payment in advance or authority to ship the goods subject to a sight draft drawn with bill of lading attached (SD/BL), which is deposited with some local bank by the seller and forwarded to a bank in the customer's city for collection. Upon receipt of the draft with the bill of lading attached, the local bank notifies the customer, and upon receiving payment of the amount for which the draft is drawn it turns over to him the bill of lading, thereby making it possible for him to obtain the goods from the carrier. The bank then remits the amount collected to the seller through the bank from which it received the draft for collection.

In event the customer objects to having his orders filled in either of these ways, it is often possible to arrange to have the

To (name of creditor)

If you will let B have the following goods:

....

....

....

....

I will guarantee the prompt payment for them.

Signed

....

Form 10. Informal Guaranty

account secured by someone of greater responsibility who is willing to obligate himself as guarantor or surety of the account up to a certain amount. In some cases this is provided for by means of a simple letter from the guarantor to the seller, stating that the guarantor will insure payment of the account up to a certain amount (Form 10). In others a formal guaranty is drawn up on forms provided for that purpose (Form 11).

Cincinnati, Ohio

To (name of creditor)

For value received, I hereby guarantee the prompt payment, to The Armour Packing Co., of the account of .... which is or may become due them, to the extent of $.........., hereby waiving notice of the extension of credit or delinquency of payment.

This guaranty to continue until removed by me in writing.

Signed

....

Form 11. Formal Guaranty

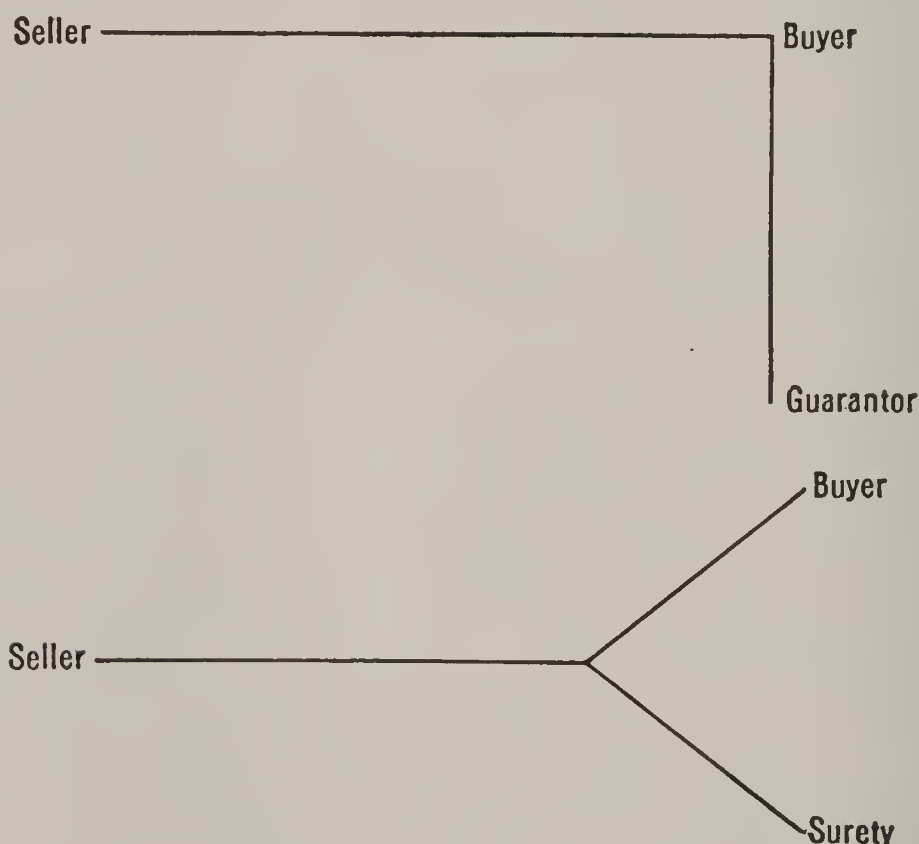
Distinction between Guaranty and Surety

Although the terms are not always used with precision and are used almost interchangeably there is a distinction between the two forms of obligation of guaranty and surety that should be observed. Guaranty is a conditional promise to answer for the debt of another in event the principal debtor cannot be compelled to pay. It is to this effect—"I will pay in case he *can* not." The guarantor is the one who gives the guaranty; the guarantee is the one to whom the guaranty is given, or the creditor; the principal is the one whose debt is guaranteed, the debtor. Surety is a promise to become equally liable with the principal for the payment of the debt, being to this effect—"I will pay in case he *does* not."

While the two obligations are very similar and the object of both is the same, namely, that of binding one person for the benefit of another, there are differences in their liabilities:

1. The contract of a guarantor is his own separate undertaking, whereby he agrees to perform the obligation in case the principal cannot be compelled to, and his liability does not, therefore, accrue until all rights against the debtor have been exhausted by the principal. Perhaps a better conception of the relation thus created can be gained by remembering that at the outset a guaranty is a contract but not a debt.

2. A surety binds himself equally with his principal for the due performance of the obligation and is liable from the beginning *ab initio*. He is therefore not entitled to notice of default of the principal, and if the obligation is not met promptly, he can be sued immediately. The legal relationship of the three parties in a guaranty and a surety may be represented graphically as follows:



Distinction between Guaranty of Payment and Guaranty of Collection

However, the obligation undertaken by a guarantor may be either a guaranty of payment or a guaranty of collection. The distinction is important because in the first case the guar-

antor agrees to pay if the principal debtor does not, whereas in the second he agrees to pay only when it has been demonstrated that the debt cannot be collected from the principal. So as concerns the credit man, a guaranty of payment corresponds in effect to a surety obligation, because upon default in payment the creditor has the right to proceed against the guarantor immediately.

Continuing Guaranty

A continuing guaranty is an agreement whereby the guarantor agrees to be responsible for goods purchased by the principal from time to time in the future; and in which a maximum amount is almost always stipulated, beyond which the guarantor will not be bound (Form 12).

For Value Received, and in consideration of The Cudahy Packing Co., selling and delivering to ....
of .... such meats, provisions, and other of their products as .... may order from time to time, ...
Do Hereby Guarantee the payment to the said The Cudahy Packing Co., at maturity of bills, or at any time thereafter on their demand, for all such purchases made by the said ....
during the period of .... years from the date hereof, to the amount of .... Dollars.

That .... guaranty herein expressed is for a running account against the said .... and is a continuing guaranty for the payment of any sum, or sums, owing thereon to the aforesaid sum of .... Dollars. Hereby waiving notice of acceptance of this guaranty, notice of maturity of purchases, and default in payment. It is expressly understood that any indebtedness of the said .... to The Cudahy Packing Co., over and above and in excess of the aforesaid sum of ....
Dollars is at the risk of The Cudahy Packing Co., but such additional indebtedness will not alter or vitiate .... guaranty expressed for the said sum of .... Dollars.

Dated at .... this ...... day of .... 19....

Witness:

.... [Seal]

Form 12. Continuing Guaranty

Consideration

When the contract of guaranty is entered into at the same time as the contract of sale which it guarantees, no special consideration is necessary to support the promise of the guarantor. When, however, the contract of guaranty is made subsequent to the contract of sale, a new consideration moving from the creditor is required to make the guaranty binding.

> EXAMPLE: Suppose A writes to C: "If you will fill the following order for B, I will guarantee payment for the goods." The filling of the order constitutes sufficient consideration to support C's promise.
>
> Suppose, however, the order has already been filled when A writes C: "I hereby guarantee B's debt to you." This promise would be unenforcible for lack of consideration to support it. If, however, such promise were given in consideration for an extension of time to B in which to pay, the promise of C would be binding.

Notice of Acceptance by Guarantee

Where the contract of guaranty is entered into at the same time as the contract of sale, no notice by the guarantee that he accepts the guaranty is necessary. In the case of a continuing guaranty, where A, the guarantor, insures C payment for all goods sold to B during the ensuing year, the authorities are somewhat divided as to whether C must notify A that he accepts the guaranty, or whether the filling of the order constitutes an acceptance. The weight of authority seems to hold that notice must be given in such a case. However, in view of the conflict of authority, it is always advisable to notify the guarantor that his guaranty had been accepted.

Notice to Surety and Guarantor on Default of Principal

Unless otherwise expressly specified in the agreement, a surety is not entitled to notice in case the debtor fails to fulfil his obligation. Whether the creditor must notify the guarantor that the debtor has defaulted in payment, is a disputed

question. Some states require no notice, while others do. It is generally held, however, that a guarantor is entitled to notice of default within a reasonable time after the default occurs; also, that the creditor should first use due diligence to compel performance by the principal debtor before proceeding against the guarantor. Consequently, if the guarantor can show that he suffered any loss by reason of his failure to receive such notice, the weight of authority is to the effect that he can escape liability, unless it is otherwise expressly agreed in the contract of guaranty. By "due diligence" is meant that the creditor shall bring suit against the debtor promptly upon default, and shall use the customary process of court to obtain satisfaction of his claim. In many jurisdictions it has been held, however, that if the debtor is insolvent, the creditor need not sue.

As in the case of giving notice of acceptance, the prudent course to pursue under the circumstances is for the creditor to notify the guarantor of the fact that there has been a default in payment by the debtor and that the creditor looks to the guarantor for payment.

Discharge of Guarantor

The guarantor is released from his obligation by the following:

1. Alteration of Contract. A guarantor can be held liable on his contract of guaranty only as he made it. If the creditor and principal debtor agree to make any change in it, without the consent of the guarantor, the latter will cease to be liable.

2. Release of the Debtor. If the creditor releases the debtor from his obligation, intending to look to the guarantor for payment, such a release also discharges the guarantor, unless he consents to it. An involuntary release on the part of the creditor, such as a discharge in bankruptcy, constitutes an exception.

3. Extension of Time to Debtor. If the creditor grants an extension of time in which to pay to the debtor, without the consent of the guarantor, the latter is discharged. This ground of release is sometimes anticipated and avoided by means of a provision in the contract which permits a change in the original terms of sale between the seller and purchaser.

4. Surrender of Securities by Creditor. If the debtor surrenders securities held as collateral for the payment of the debt, the guarantor is discharged to whatever extent he may be injured as a result of it.

5. Death of Guarantor. If the guarantor dies before the contract of guaranty has been acted upon by the creditor, the death of the guarantor has the same effect as an express revocation. If, however, the creditor has incurred any liability under the agreement, the guarantor being answerable therefor at the time of his death, his estate also remains liable therefor. After the death of the guarantor, however, no further credit may be extended in reliance on his guaranty, but his estate remains answerable for whatever indebtedness has already been incurred.

6. Main Contract Unenforcible. If the main contract between the creditor and debtor is illegal and therefore unenforcible against the debtor, for such causes as fraud, a usurious rate of interest, illegality, etc., it is likewise unenforcible against the guarantor. Where the contract is voidable, the fact that the debtor is an infant, or a person of unsound mind, will not release the guarantor. Such a defense is personal to the debtor, and the guarantor may not avail himself of it.

Remedies of Guarantor

A guarantor who has paid the obligation of the debtor is entitled to the following remedies:

1. Subrogation to Rights of Creditor. After satisfying the creditor's claim, the guarantor is entitled to be sub-

rogated to the rights and collateral securities held by the creditor to secure payment of the debt.

2. Indemnity Against Principal. After the guarantor has paid the debt to the creditor, he is entitled to turn around and collect it, if possible, from the debtor.

3. Contribution. If two or more persons are jointly liable on a contract of guaranty, and one of them pays the entire debt, he is entitled to a pro rata reimbursement or contribution from the other coguarantors.

Disability of Bank

A bank cannot guarantee an account, because it cannot be legally bound under such an agreement. However, any assumption of risk, or assurance of protection short of an actual guaranty, creates a strong moral obligation.

Statute of Frauds

The obligations of both guaranty and surety must be in writing to be enforcible. Section 4 of the Statute of Frauds provides:—"all undertakings to be answerable for the debt, default, or miscarriage of another must be in writing to be enforcible."

CHAPTER XIX

CHATTEL MORTGAGES

Definition and Nature

In arranging for the extension of a line of credit to some buyer of doubtful responsibility, it is not an uncommon practice for credit men to accept a chattel mortgage (Form 13) as collateral security on the account. It also not infrequently happens that in investigating the financial responsibility of a merchant or firm it is found that the personal property owned by the merchant is covered by one or more chattel mortgages.

A chattel mortgage in most jurisdictions is an instrument whereby the owner of personal property transfers title to such property to another as security for the payment of a debt, subject to being defeated upon payment of the debt. The legal title is vested in the mortgagee and becomes absolute upon default. Such title, however, is extinguished by the payment of the debt by the mortgagor.

A chattel mortgage differs from a mortgage upon real estate in the following particular: A real estate mortgage is only a lien and conveys no title, whereas a chattel mortgage transfers the title at once, subject to a defeasance by the performance of the obligation for which it was given. However, the law in regard to chattel mortgages differs materially throughout the states. While in most states a chattel mortgage is regarded as an absolute transfer and conveyance of the property, there are some states in which it is held that title does not pass to the mortgagee, but that he gets only a lien on the mortgaged property.

Chattel Mortgage

Know All Men by These Presents:

That I, Harry J. Thomas, of New Rochelle, New York, am indebted unto W. H. Richards, of New York City, New York, in the sum of Eighty-Five Dollars ($85), being for goods sold and delivered to me: Now, for securing the payment of the said debt, and interest from the date hereof, to the said W. H. Richards, I do hereby sell, assign, and transfer to the said W. H. Richards all the goods. chattels, and property described in the following schedule, namely.

(*List of property*)

Said property now being and remaining in the possession of myself, at my store, No. 165 Orchard Street, New Rochelle, New York.

Provided always, and this mortgage is on the express condition, that if the said Harry J. Thomas shall pay to the said W. H. Richards the sum of Eighty-Five Dollars ($85), within one year and six months from the date hereof, with interest at Six per cent (6%) per annum, which said sum and interest the said Harry J. Thomas hereby covenants to pay, then this transfer is to be void and of no effect; but in case of non-payment of the said sum at the time or times above mentioned, together with interest, then the said W. H. Richards shall have full power and authority to enter upon the premises of the said party of the first part, or any other place or places where the goods and chattels aforesaid may be, to take possession of said property to sell the same, and the avails (after deducting all expenses of the sale and keeping of the said property) to apply in payment of the above debt; and in case the said W. H. Richards shall at any time deem himself unsafe, it shall be lawful for him to take possession of such property and sell the same at public or private sale, previous to the time above mentioned for the payment of said debt, and apply the proceeds as aforesaid, after deducting all expenses of the sale and keeping of said property. If from any cause, said property shall fail to satisfy said debt, interest, costs, and charges, the said Harry J. Thomas hereby covenants and agrees to pay the deficiency.

In Witness Whereof, I have hereunto affixed my hand and seal, this eleventh day of February, nineteen hundred and twenty.

Harry J. Thomas [L.S.]

In the presence of:
George H. Goodwin

(*Notarial acknowledgment in due form if required*)

Form 13. Chattel Mortgage

Form and Requisites

In the absence of statute no particular form is necessary to constitute a chattel mortgage. The simple statement that a creditor is to have a lien and that on default he may take possession, sell the property, and apply the proceeds upon the lien, is sufficient. In other words, any form of words by which the title is transferred as security for a debt or obligation of any kind, to be defeated by the payment of the debt or perform-

ance of the obligation, suffices to serve as a chattel mortgage. Statutes have been passed in practically all states, however, requiring the recording of chattel mortgages in order to make them valid and enforcible against third parties.

Parties

All persons who are legally competent to make a contract may also make a chattel mortgage. A man may make a valid chattel mortgage to his wife. A chattel mortgage may be executed by an agent who is authorized for the purpose, and his authority may be either verbal or written, or by way of subsequent ratification. A member of a firm may, without the knowledge and consent of his partners, make a chattel mortgage, covering the partnership property, in the firm name to secure a firm debt.

Subject Matter

It may be stated generally that every kind of personal property may be mortgaged. For example, a life insurance policy may be the subject of a chattel mortgage. A chattel mortgage simply requires a subject in existence, together with an ownership and control in the mortgagor, and can have no validity where the property is not in either actual or potential possession of the mortgagor.

Description of Property

The general rule as to description of the mortgaged property is that any description will suffice that will enable third persons to identify the property by inquiries and evidence. A chattel mortgage conveying "all personal property whatever owned by the mortgagor" is too indefinite and cannot be said to give notice of the lien to execution creditors. A general description covering all the goods in a store and stock in trade has been held to constitute a sufficient description. However, when made to include "all increase and decrease thereof," it

has been held to be void. Several states have passed statutes providing that a chattel mortgage on a stock of merchandise subject to resale is fraudulent and void. Other states hold that such a mortgage is valid if it requires the mortgagor to apply the proceeds derived from a resale of the goods to the satisfaction of the mortgage debt. Where a schedule of the property is annexed to the mortgage, it becomes a part of it and both are construed together. Where there is a conflict between the two, the provisions of the mortgage prevail.

Execution and Delivery

Delivery and acceptance are essential to constitute a valid mortgage. There must be some act showing that the grantor intends that it shall take effect and that act constitutes delivery to the grantee, actual or presumed. Merely to sign and acknowledge a writing and then retain it in one's possession, conveys no title.

The date recited in a chattel mortgage is only prima facie evidence of the time of its execution and the true date may be shown by oral evidence.

Filing

If the possession of the chattel property, as well as the title or the lien, always passed to the mortgagee, few questions would arise of interest to others than the immediate parties, unless the whole transaction could be attacked as a fraud upon the mortgagor's creditors. But if the mortgagor, as is frequently the case, is to remain in possession of the chattel, the rights of third persons who, without actual notice of the mortgage or lien, purchase the chattel from the mortgagor in possession, or who otherwise change their position, relying on the apparent ownership attributable to unrestricted possession and control of the chattel, may easily become involved.[1]

In order to avoid this, filing and recording statutes have

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1 Credit Men's Manual of Commercial Laws, p. 114.

been enacted in practically all the states, making it possible for the mortgagee not in possession to protect himself against the claims of subsequent purchasers or subsequent mortgagees. Under these acts the filing or recording of the mortgage in the proper office of record serves as notice to the world of the mortgagee's interest in the chattels. That of New York affords a typical example, and provides:

> Every mortgage or conveyance intended to operate as a mortgage of goods and chattels hereafter made, *which shall not be accompanied by an immediate delivery and be followed by an actual and continued change of possession* of the things mortgaged, shall be absolutely void as against the creditors of the mortgagor, and against subsequent purchasers and mortgagees in good faith, unless the mortgage, or a true copy thereof, shall be filed as directed.
>
> Every mortgage filed in pursuance of this act shall cease to be valid as against the creditors of the person making the same, or against subsequent purchasers or mortgagees in good faith, after the expiration of one year from the filing thereof, unless within 30 days next preceding the expiration of each and every term of one year after the filing of such mortgage, a statement describing the mortgage, stating the names of the parties .... shall be again filed in the office of the clerk aforesaid ....

The term of filing varies from one year in New York and Michigan to six years in Minnesota.

Where Filed

The actual place of residence of the mortgagor is, with few exceptions, the place where a chattel mortgage must be filed, and creditors of the mortgagor, subsequent purchasers, and mortgagees in good faith, may show that the place mentioned in the mortgage as his residence was not such in fact. However, the general creditors of a mortgagor of chattels have no right to assail a mortgage as invalid until they have secured a lien thereon by levy under a judgment and execution, or by some other method acquired a legal or equitable interest in the property.

Effect of Omission to File

A failure to file a chattel mortgage where there has been no change of possession of the mortgaged property renders it void as to the existing creditors of the mortgagor, and the mortgagee cannot thereafter acquire title to the property by taking possession and selling it under the mortgage, although the mortgage was given in good faith to secure an actual indebtedness. In fact, the courts have gone still further and held that such a mortgage is not valid as against an antecedent creditor, although it was filed before the creditor acquired a lien upon the property by judgment and execution. However, a mere creditor at large, without some process for the collection and enforcement of his debt, is not in a position to question an unfiled mortgage given by his debtor, which is otherwise valid.

How Discharged of Record

Whenever the mortgagor, or any person obtaining title to mortgaged property, shall present to the recorder in whose office a chattel mortgage is filed, a certificate ("satisfaction piece") from the mortgagee, or the holder thereof, to the effect that such mortgage has been paid or satisfied, it is the duty of such recorder to file such certificate in his office and discharge the mortgage, by writing in the record opposite the entry the word "discharged" with the date thereof.

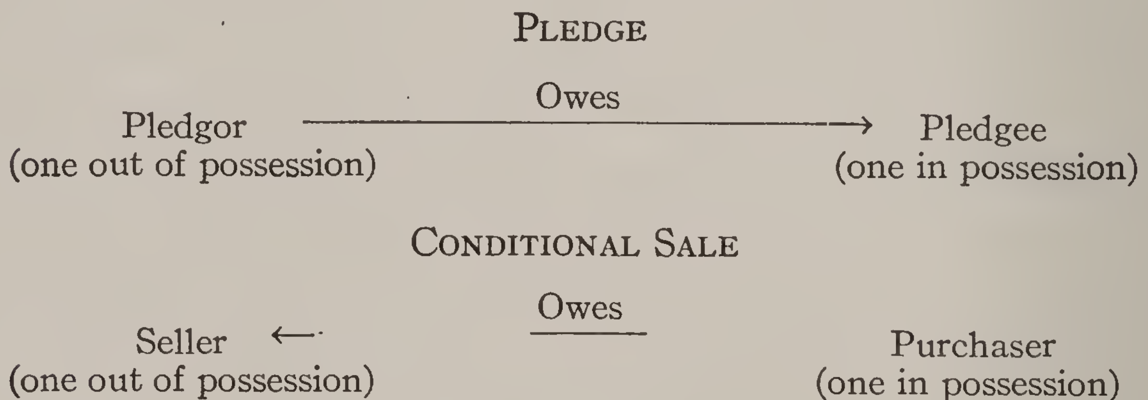
Distinction between Chattel Mortgage and Conditional Sale

A chattel mortgage is sometimes said to be in essence a "conditional sale with a condition subsequent to the passing of title." The mortgagee of goods becomes the transferee of the legal title subject, however, to defeasance upon performance by the mortgagor of the condition imposed by the mortgage; but if for any reason the mortgagor fails to perform the condition imposed by the mortgage, the title of the mortgagee then becomes absolute. The interest retained by the

mortgagor in such cases is in the nature of a lien, or equity of redemption. In the case of a conditional sale, however, the seller retains something more than a lien; he actually retains the legal ownership, after the possession of the property passes into the hands of the purchaser, and he may, upon the failure of the purchaser to keep his contract, recover actual possession. A chattel mortgage transfers title, and may or may not transfer possession, while a conditional sale transfers possession but not title.

Distinction between a Conditional Sale and a Pledge

From a strictly legal point of view, the nature of both the conditional sale and the pledge is apparently the same, in that possession but not the legal title is transferred in both instances. The distinction, however, lies in the fact that the obligation flows in the opposite direction in the case of a pledge from that in the case of a conditional sale, as shown in the subjoined diagrams:



Also, in the nature of the remedy for a breach or non-performance of the obligation involved, in that the pledgee may collect what is due him by a sale of the property pledged; whereas the seller, in the case of a conditional sale, may retake or recover the property.[2]

[2] For a complete digest of the state statutes on chattel mortgages see Credit Men's Manual of Commercial Laws, p. 120.

CHAPTER XX

CREDIT INSURANCE

Defined

The theory of credit insurance, for some reason, is often misunderstood and there has been a tendency to criticize its principle for faults which are due to poor methods in applying and carrying out the principle in practice. Properly presented, however, the principle is as easily grasped as that of any other form of insurance, and it is a subject which should be given due consideration by every credit man.

The principle underlying insurance of all kinds is the same, namely, that of equitably distributing the excessive or unexpected losses of a few among a large number, each of the policyholders paying a fixed premium for having his risk of loss assumed by the others. In other words, all insurance is based on the law of averages, and credit insurance is simply the application of this principle to bad debt losses. Credit insurance may then be defined as the application of the principles of indemnification for losses to the risk incurred in the extension of mercantile credit.

The Initial Loss

All sales or transfers of goods on credit involve some risk of loss to the party extending the credit, and when these risks are accepted from day to day over an extended period, the creditor anticipates losses from some of them and provides against these expected losses by setting up a reserve or special allowance to cover such losses. The amount to be set aside for this purpose is ascertained by computing the average percentage of loss over past years, and then making allowance

for the same percentage on the estimated volume of sales for the coming year. This normal loss, averaged from previous years' figures, properly constitutes a part of the expense of doing business, and should be considered as such along with the other production costs. In other words, a certain normal loss figured in advance is, under such circumstances, not a loss at all, but an anticipated part of the expense of doing business on credit, which may be added to the sale price of the goods.

Scope of Credit Insurance

In addition to this normal or initial loss which the house itself must sustain, business done on credit is always subject to unexpected and unlooked for losses due to financial difficulties brought about by crop failures, floods, business depressions, or other natural causes, which nothing short of divine foresight could have anticipated, and it is only against this abnormal or excessive loss that the insurance company affords protection to the policyholder. In other words, credit insurance does not insure a merchant for his total loss, but against abnormal losses only.

In negotiating for credit insurance three things must be determined:

1. What sum shall be fixed as the normal loss of the house seeking credit insurance, above which losses will be indemnified?
2. What rate or premium shall be charged by the insurance company?
3. What shall be the fixed limit of indemnification beyond which the company will not be bound?

Ascertaining the Initial Loss

As has already been explained, to fix the amount of the initial loss to be borne by the insured, the net losses for several years back are compared with the volume of sales for each of these years, in order to determine the average percentage of

loss from year to year. For example, if the sales for the past five years averaged $1,000,000, and the losses during the same period averaged ½ per cent, the initial or normal loss to be borne by the insured would be fixed at $5,000, the insurance company being liable only for such losses as are in excess of $5,000.

Another method that is sometimes used for computing the known, or initial, loss consists in dividing the total losses from bad debts for the preceding five years by five, and the quotient is taken as the initial loss.

Determining the Insurance Premium

As in the case of other forms of insurance, the premium or rate varies with the degree of risk involved. In credit insurance the basis used for estimating the degree of risk consists of a fixed schedule of rates for each class of business, based on statistics of failures running over a number of years, and carefully compiled by the mercantile agencies. These tables correspond to and are used in a manner similar to the mortality tables of life insurance companies. In addition to this general information, consideration is also given to the particular hazards of the business of the insured, their class of customers, the volume of business, size of accounts, terms of sale, and the general credit policy of the house. From all these facts the premium rate is determined.

An additional premium is sometimes necessary and is adjusted according to the volume of sales. Where such additional premiums can be collected, the policy is called "assessable."

Limitations of the Bond

Credit insurance, as has already been pointed out, presupposes a willingness on the part of the insured to assume a normal or initial loss. A further restriction incorporated in the policy is that the extent to which protection is afforded

against loss sustained in selling customers who are not rated, or poorly rated, by Bradstreet or Dun, is limited. Both of these agencies make use of the classification of "rated" and "off-rated" accounts, the former consisting of those having a capital rating followed by a first- or second-class credit rating, and the latter consisting of those having a lower rating than the former, or none at all. Statistics show that the heaviest losses are sustained from the off-rated class of accounts, and for this reason the insurance company limits its liability on off-rated accounts by stipulating that only a certain percentage of the bond shall apply to such accounts in figuring the year's losses.

Types of Policies

Two principal types of policies are being written, one known as the "limited," and the other the "unlimited."

The limited policy is one having a face value which is the maximum total liability of the insurer. Thus, if the policy has a face value of $25,000 and the insured sustains losses aggregating $50,000 he is only partially insured even though all the loss accounts were within conservative credit limits.

The unlimited policy makes no provision for a maximum total liability and has no face value. As long as the individual losses come within the amounts specified in the table of ratings, contained in the policy, they will be paid regardless of the total amount.

Both types are written with many variations. But no loss is covered under a policy unless the agency rating of the debtor to whom the goods were shipped shall have been within the table of ratings contained in the policy. If the name of the debtor does not appear in the latest published book, then the latest report of said agency shall govern, if that report is within a specified time of shipment (usually this is three or four months).[1]

[1] See Riegel and Loman, Insurance Principles and Practice, p. 324.

Method of Operation

To illustrate the method of operation employed by credit insurance companies, let us assume that a firm's gross sales over a period of five or ten years have averaged $500,000 a year, and that the percentage of loss suffered during the same period amounted to ½ per cent, or $2,500. In such a case, if the aggregate loss from bad debts is less than $2,500, the firm recovers nothing in the nature of indemnity from the insurance company. If the loss exceeds $2,500, the excess is recovered in full up to the amount of the bond, subject to the above restrictions. For example, it may provide that the loss on rated accounts is to be covered in full up to an agreed percentage of their capital rating; whereas on the off-rated accounts protection may be further restricted to only a certain percentage of the loss sustained, or possibly no protection afforded at all.

Advantages of Credit Insurance

It is argued in favor of credit insurance that it gives the business man greater control over his costs, inasmuch as he need only add the premium, or cost of his insurance protection, to his normal or initial loss and other fixed costs to ascertain the exact cost of production, thus enabling him to compute his anticipated profits with a greater degree of certainty and accuracy. It is also contended that it tends to make the credit man more careful, and forces him to keep a closer watch on his accounts in order to make certain that he keeps well within the provisions of his policy. He must strictly observe the changes in the agency capital or credit rating of his customers, for the losses are adjusted on a basis of the latest information that was available at the time the goods were sold. Thus it is argued that instead of "taking the head off the credit man's shoulders," it serves as a guide to the credit man, and induces the exercise of care and caution on his part in the extension of credit.

A third argument advanced in its favor is that when the risk of excessive loss from bad debts is insured against, the house can take larger chances in extending credit and thus increase their volume of business.

Objections to Credit Insurance

Zimmerman in his article on "Credit Insurance" points out the disadvantages as follows:

> The value of credit insurance must depend largely on the credit man; its weak points appear plainly in the very presentation of its advantages. It can be abused much more easily than well used. To a credit man the least inclined to shirk his responsibility or take too long a chance it will prove fatal and against the best interests of his house. The very fact that he is dividing responsibility and putting the possible loss on someone else will make him more lenient in granting credits. The specific facts in regard to a customer which a credit man must watch to keep within the requirement of his bond are not extremely significant; the bookkeeper or office clerks can keep track of them. And a credit man carrying insurance may even disregard them altogether, figuring that he can take the extra chance even though his credit extensions are overstepping the stipulations of his bond. None of the arguments advanced as curbs on the caution of the credit man will stand examination. The credit man's house will not be liable to hold a loss from bad debts against him if it is covered by insurance, provided that he can show that he has increased sales by taking this chance. Credit insurance companies themselves are compelled to confess that business men using their policies are apt to try to make money off them. That a high loss one year will raise their future normal loss and premium rate will not be likely to worry credit men. In short, the weak credit man is quite likely to be further weakened by carrying credit insurance and to substitute the security of his bond for good judgment.
>
> It is often questioned if credit insurance, as now conducted, has any value to the strong, able, watchful credit man, and whether it does not constitute a burden on him for the benefit of his weaker brother. Under the present insurance policy the credit man really does not make his own credits, and does not, therefore, make credits on a proper basis. On the one

hand, if, hesitating to grant a doubtful credit, he does extend it because the case is covered by his bond, surely in this case it is not his judgment, but the protection of the bond, that makes the credit. On the other hand, in refusing against his own better personal judgment to grant credit because such extension will for some reason not come within his policy requirements, here again it is not he who is making the credit.

If the normal loss of a large firm for a long period of years has averaged a certain percentage of its gross sales, it may wonder why it should pay out a considerable sum of money to be protected against a loss above this normal, for it is extremely probable that, even though in some one year its losses will exceed this percentage, the average of the next decade will be no higher, and its premium will only be so much additional to be charged to the loss account.

Credit insurance, as it is at present employed, protects the insured to a limited degree against unexpected credit losses. Whether or not business men should carry such insurance depends largely upon the answer to the following question: Can a comparatively equal degree of protection be obtained in any other manner and at a smaller expense? Carrying insurance of any kind is a considerable expense, and if this expense can be saved, over a period of years, the savings will cover or possibly more than cover the ordinary risks of the business.

Proposed Plan of Shipment Insurance

One of the greatest objections to present methods of credit insurance companies is the fact that the business man's accounts are considered collectively and not individually, a characteristic which practically destroys its analogy to other kinds of insurance. Fire insurance companies, for example, do not divide property risks into certain classes and place each piece of property insured in one or the other of these classes, but investigates and appraises each risk separately. A step in this direction has for a long time been considered by the Credit Clearing House, probably the largest as well as one of the most efficient collection agencies and adjustment bureaus in the country, in

an effort to overcome the objection and meet the potential need for a different form of credit insurance. For years they have been operating a credit checking system, or interchange bureau, for textile lines exclusively, and as a result they have accumulated a very extensive and accurate mass of information on the strength of which they feel that they are in a position to undertake to guarantee shipments in this manner:

A credit man receives an order concerning which he is in doubt. Instead of asking for reports or writing the customers for information, he will call the Credit Clearing House, and, based on the information they have in their files, they will tell him either to ship or not to ship. In event they tell him to ship and a loss on the shipment is incurred, they are obligated to make it good, and in every instance where they tell him not to ship, a report is to be immediately sent showing just why, in their opinion, the risk is dangerous.

Advantages and Disadvantages

Just as there are two sides to every story, there would seem to be both distinct advantages and disadvantages to such service. For instance, it would obviously mean much to a credit man to be able to obtain an immediate ruling on a doubtful order, as it would relieve him of the time and trouble of making the usual investigation and also enable him to act without delay.

On the other hand, it is conceivable that the difference in the volume of business transacted by two competing houses might be largely due to the respective policies carried out by their credit managers, one possibly being extremely liberal and the other ultra-conservative. In other words, presented with the same information relative to a certain customer, the one would take a chance and ship the order, whereas the other would "play safe" and refuse to fill it. It is obvious what the result would be if the passing on such business is to be left to a practically disinterested third party, whose success and

profit depends, not on the volume of business done by the insured, but only on the percentage of loss suffered. Are not large salaries paid to credit men and the heads of credit departments for the very purpose of deciding such doubtful cases in the best interests of the house? And is not this service, in substance, an attempt to relieve them of the responsibility which their discretion, judgment, and experience should best enable them to assume?

If such a service is found feasible and desirable, the Credit Clearing House is unquestionably well qualified to render it because of the very extensive data acquired through the operation of their credit interchange bureau, and the supplemental information procured through their national collection agency. It is simply an advanced and specialized form of agency service and quite an innovation in credit work. Just what degree of success it will receive remains to be seen.

CHAPTER XXI

GRANTING OF EXTENSIONS

Cardinal Principles

If any cardinal rule or principle can be laid down as governing the granting of extensions, it is that great conservatism should be practiced in granting additional time to delinquent debtors, and that promiscuous requests for additional time should be discouraged. The efficient credit man will always demand a good and sufficient cause and reason for the delay in payment before any extension is granted. In fact, he is placed on guard just as soon as a debtor has failed to pay his account when due, and it is only reasonable that he should want to know, not only the reason for the delay, but also the prospects for payment within the additional time requested before consenting to the extension and refraining from taking any radical action to protect himself.

In the first place, a customer asks for an extension only when he is not in a position to settle his account—for some reason which may be either good or bad—and the credit man is hardly in a position to pass on the merit of his request until he knows why such a request is necessary. A merchant finding himself in this condition must seek accommodation or relief in one of two ways—he may borrow money to pay his bills, or obtain extensions of payment from his creditors. Being insolvent, for the time being at least, he would naturally experience difficulty in negotiating a loan; so the latter alternative is the one usually chosen.

Preliminary Investigation

Sooner or later every debtor, struggling in the throes of insolvency, will be compelled to ask for extensions to obtain

relief from the ever-increasing pressure of his creditors, and the past record of an active account will often "tell the story" without asking for any additional information from the debtor himself. In fact, the first step taken by an experienced credit man in handling such a request is to get the following data:

Credit limit
Amount outstanding
How pay
Bills overdue

This is of so frequent occurrence that established houses have little slips, or forms, made up, which they can simply attach to the correspondence and pass over to the bookkeeper handling the account.

It is the policy of many firms to have the bookkeeper note in red ink at the top of his ledger the credit line placed on each account. This enables him to supply a sort of collateral check on the shipments that are made; e.g., if in entering an invoice covering a shipment to A, amounting to $1,500, he notes that A's credit line is only $500, the error on the part of the credit department in checking the order is immediately found. Without this check of the bookkeeper the error would very likely pass unnoticed until the account became overdue and was submitted to the credit department for collection.

Under "How pay" the bookkeeper will not rate the customer as prompt, good, or bad—this being a prerogative of the credit man—but will list the corresponding charges and payments for several months previous.

Practical Illustrations

Let us assume, then, the investigation discloses the following facts:

1. A has been trading with the firm for several years, and, while he has taken discount only intermittently, he has always paid his bills in a prompt and businesslike manner. At present his account shows his credit line full, with two bills past due—

one 15 days and the other 30 days. He is now requesting a 30-day extension, within which he promises to settle the entire account.

2. Six months ago B was discounting his bills, but it was only a short while before he discontinued taking his discount and paid his bills at maturity. Of late, however, he has been getting a little slow, taking overtime in several instances, and his account now shows his credit line full and several outstanding bills overdue. He is also asking for an extension of 30 days within which he promises to make a payment on the account.

When confronted with two such cases the experienced credit man would reason somewhat as follows: A certainly has a clean record; in fact, it is such as clearly to entitle him to consideration in his present position. He has probably overbought and not found business as good as anticipated. Another 30 days should prove sufficient for him to straighten out his finances, and he has promised to settle the entire account within that time. There is every reason to believe that he will fulfil his promise, or at least is honest in his expectation that he will.

As to B it is obvious from his record that he is gradually going from bad to worse, and an extension under such circumstances is not to be thought of; in fact, his request serves as a warning to "get out from under" as quickly as possible and before the inevitable fall comes.

Having decided to grant A the accommodation requested, but to deny a similar favor to B, the next step for the credit man to consider is the proper manner in which to convey his decision to them. One might reasonably suppose that the only thing for him to do is to write both of them a pleasant letter—to A telling him that he will be granted his request, on his assurance to settle the account within 30 days, and to B telling him how much the credit man regrets having to refuse his request. Such simple procedure, however, would hardly be in keeping with the extreme conservatism advocated in this connection.

Showing Leniency with an Account

The tactful credit man will wish to take advantage of the opportunity to impress upon A the magnitude of the favor he is asking and to draw him out a little with a view to ascertaining the true reason for his temporary embarrassment. Hence some such letter as this would seem more likely:

> We have your favor of .... and are rather surprised to learn that your affairs are in such shape as to necessitate your request for additional time in which to settle our account.
>
> It is strictly contrary to the general policy of this company to grant, or allow, additional time in payment of our bills, but we appreciate the very nice business with which you have been favoring us, and to show our appreciation, we are rather disposed to favor you in this instance, provided the cause of your present condition is such that another 30 days will suffice to remedy, and concerning which we should like to have additional information, so that we may give the matter our careful consideration.
>
> We shall, therefore, reserve our decision until we have heard further from you in this connection.

Then, when advising him of the decision, the extension should be cheerfully granted, and the spirit of the letter such as to convey the feeling that it gives the credit man pleasure to be able to accommodate him:

> We have your favor of .... in further reference to your account with us, and having carefully considered your reasons for requesting this extension, we are pleased to advise that it will be entirely satisfactory for you to extend payment of your account 30 days.
>
> We are very glad to be able to grant your request and trust another 30 days will bring about a decided improvement in your financial affairs.

Closing an Account

Since it has been decided to withdraw B's credit line entirely, this would undoubtedly be a very inopportune time to advise him accordingly and some such letter as the following would seem tactful under the circumstances:

We have your favor of .... requesting an extension of 30 days in payment of your account with us, and are very sorry to learn your affairs are in such shape as to make such a request necessary.

It has for years been the policy of this company to decline to grant any extensions in the payment of our bills, except under very unusual circumstances, and while we appreciate the business with which you have favored us, and much as we would like to accommodate you by granting your request, in justice to our other customers, we cannot see any special reason for deviating from our general policy in this instance.

Furthermore, we feel that we have been very lenient with you in the past, and wish to call attention to the numerous occasions on which you have recently taken overtime on our bills. We simply cannot allow you to continue to take advantage of us in connection with our terms of payment, so unless we receive your positive assurance that our terms of payment will be strictly observed in the future, we shall consider it necessary to withdraw the line of credit placed on your account.

Your account is now considerably past due, and under the circumstances, we shall have to insist upon an immediate settlement.

Legal Aspects of Extensions

By an "extension" is meant the granting of further time on the part of a creditor to a debtor in which to pay his account.

It is a well-established rule of law that when a legal obligation already exists, a cumulative, or second, promise to perform it, unless based upon a new consideration, is a nullity. Such a promise adds nothing to or takes nothing from the original obligation, and being without consideration to support it, is not binding.

Applying this principle of law to the facts presented in the ordinary request for an extension, it means that a mere agreement to give additional time, or to extend the date of payment, without any advantage coming to the creditor from the delay, does not bind the creditor because the debtor's promise to pay is only cumulative.

In other words, there must be some advantage accruing to the creditor in order to make the extension binding. However, the thing surrendered by the debtor may be of little value and the benefit to the creditor very slight; but if present, it constitutes an adequate consideration.

When the Acceptance of a Note Is an Extension of Credit

Where a bill or promissory note is given by a debtor in consideration of being granted an extension, by changing the nature of his indebtedness from an open book account to that of a promissory note (particularly if it is an interest-bearing note) the debtor is doing something he was in no wise obligated to do by the terms of the original agreement. This would, therefore, in the author's opinion, constitute a valid consideration.

The rule may, therefore, be laid down that the acceptance of a bill or note tendered by the debtor in consideration for the granting of an extension in the time of payment of an existing indebtedness suspends the right of action thereon until the maturity of the bill or note. And the law is clear that if in *payment* of a debt, the creditor is content to take a bill or note payable at a future date, he cannot legally commence an action on his original debt until default is made in the payment of the bill or note.

As to whether or not the old claim or book account becomes merged in the note in such instances, thereby constituting what is legally termed a "novation," is a debatable point of law. This much can be said, however; if the note or bill is accepted by the creditor in *payment* of the account, the effect would be to extinguish the original debt; whereas, if it was only taken as collateral security, it would not have that effect. In other words, the legal effect of the transaction would depend upon the intention of the parties. However, the weight of authority seems to favor the doctrine that nothing short of actual payment, or the acceptance of a *higher* security, as, for example,

a note made or indorsed by a third party, will discharge the original claim. The courts are, however, united upon the rule that where a creditor accepts a bill or note in payment of a debt, the original term of credit is at least extended for the time specified in the bill or note.

Effect of Fraud

Where fraud, deceit, or undue influence enters into the transaction, the rule is different. And where a debtor, in order to bridge over a certain period within which he can dispose of his property, or safely remove himself beyond the jurisdiction of the court, secures an extension of his credit by procuring the acceptance of his note maturing at a later date, with the intent thereby to defraud his creditors; or where the note or bill is given and accepted, when the debtor knows that it will not be paid; or the acceptance is procured through false representations; or by deceitfully withholding material facts that it was his duty to disclose; the creditor may at once disregard the entire transaction, return the note, and sue upon the original indebtedness.

CHAPTER XXII

TRADE ABUSES

Definition

There is unquestionably an element of truth in the saying, "There are tricks in all trades," and while the professions are cursed with members who resort to unjustified means of accomplishing their ends, we have a corresponding element in the commercial world who resort to unbusinesslike practices to increase their profits. But instead of being called "unprofessional conduct," or "sharp practice," as it is generally referred to professionally, such practices are known in the business world as "trade abuses."

Unearned Discount

Perhaps the most perplexing problem of this nature with which the credit man has to contend is the taking of unearned discount—remitting less the discount after the discount period has expired—and in order to fully appreciate the nature of this abuse it is necessary to understand clearly just what "cash discount" is and the purpose for which it is offered.

Cash discount is a premium (not interest) allowed by the seller of merchandise to the buyer for payment of an invoice within a specified period, depending in time and amount on the terms of sale. For example, terms of 30-1-10 mean the full amount of the invoice is due in 30 days but a deduction of 1 per cent from the gross amount will be allowed provided payment is made within 10 days. The amount of such allowance varies from ½ per cent in 10 days to 10 per cent for cash in 30 days. Being therefore a part of the terms of sale it is just as much a part of the contract as the price to be paid for

the goods, and consequently a buyer has no greater right to deduct the discount after the discount period has elapsed than he has to remit on a basis of 30 cents a gallon for oil which was purchased at 31 cents a gallon.

Object of Cash Discount

The chief object of the seller in offering cash discount is to promote prompt payment and thereby reduce the risk of loss from doubtful accounts. In actual practice, however, it is found that it is the good credit risk that will always take the discount, while the poorer risks will waive the privilege and permit the account to run to maturity. The theory is that he can afford to sell the buyer with a smaller return to himself, provided he can get hold of the money within a certain time and enjoy the use of it in operating his business between the expiration of the discount period and the maturity of the bill. Such being the object of cash discount, it therefore follows that the buyer not only has absolutely no right whatever to take the allowance after the specified time has expired, but by so doing he also defeats the very purpose for which it is offered.

Here is, then, the situation with which we have to contend. We have a customer whose business is attractive and which we wish to retain, but he has taken unearned discount. Shall we demand the difference, small though it may be, as a matter of principle, or shall we overlook it for fear of offending the customer and losing his business? Theoretically, as has been pointed out, the practice is wrong and should never be overlooked or waived. But as a matter of business practice a liberal and flexible policy in dealing with this situation is necessary, because many houses, on account of keen competition and their thirst for business, countenance such unfair practices and are responsible for the attitude prevalent among the trade that to dun customers for such a small difference would be "treating 'em rough" and showing a lack of appreciation of their business, and that since such deductions are

overlooked in some houses, the same attitude is to be reasonably expected by buyers from all others.

Various Phases of the Problem

The problem has many phases, one of which has to do with the buyer who refuses to pay for goods before they have been received, and then remits less the discount. At first, this seems only reasonable; but was anything stipulated or implied in the terms of discount as to the delivery of the goods? By shipping him on open terms the seller has manifested his confidence in the buyer. So the buyer should reciprocate this confidence by believing that the seller will correct any errors that may later develop in filling his order, and should remit within the discount period if discount is to be taken, remembering it is always his privilege to await delivery and then remit the full amount at maturity.

Another phase has to do with the antedating of checks. For example, the discount period has expired on the 10th day and a buyer remits less discount on the 13th day, dating his check the 10th. His defense that the check was made out on the 10th day and the delay therefore attributable to the mail service is groundless, for a bill is certainly not paid when a check is signed, and as the post mark is conclusive evidence as to date of mailing, it is quite evident that the discount has not been earned.

Two Ways of Handling Violations

Suppose a check for the bill less unearned discount is received and the seller does not intend to waive the difference. The question is: Which is the better policy to pursue—to return the check and request another drawn for the full amount at maturity—or to keep the check and ask for another covering the difference? Certainly a more serious intent to collect the difference is manifested by the first method, as in that case the buyer can do but one of two things, either return the check,

or pay the full amount at maturity. On the other hand, the second method often proves a long and tedious process.

There are undoubtedly instances when it is prudent from a business standpoint not to make an issue of such discrepancies, and others when it is advisable to insist upon an adjustment even at the cost of losing the business, but in either case it is never wise to "nurse a grievance." First consider the facts and decide the course to pursue, and then either demand an adjustment or overlook it entirely, once the matter has been brought to the buyer's attention. Any vacillating or controversial attitude not only weakens the seller's position but lowers the respect for his firm in the eyes of the debtor.

The following letter is submitted as an example of a polite, non-offensive, yet effective way of bringing the matter of a first offense to the buyer's attention:

> We have your favor of the 10th and wish to acknowledge receipt of your check for $298.85, tendered as in full settlement of our invoice of May 1, less the usual deduction for cash discount.
>
> The limit for discounting our bills, however, is 10 days, whereas your check was not mailed until . . . .days after the discount period had expired. So you are consequently not entitled to the benefit of this deduction.
>
> Cash discount is, as you are of course aware, offered for the sole purpose of encouraging prompt payments, so it is necessary for us to have a limit within which our bills may be discounted; and as our terms are 30 days net, you will readily realize that we are not justified in making this limit more than 10 days.
>
> We are perfectly willing in this instance to overlook the delay and accept your remittance as rendered, but we do not want our action in this particular instance to be considered as establishing a precedent for the future.

Below is an example of a polite refusal to accept the check:

> We duly received your favor of the 10th in which you sent us your voucher check drawn for $298.85, which was tendered in payment of our invoice of May 21, less 1% cash discount.
>
> We wish to call your attention, however, to the fact that

our terms of payment allow 1% discount only when a remittance is sent us within 10 days from the date of the charge, and as the remittance referred to was not sent us until....days after the discount period had expired, you were not consequently entitled to the benefit of the cash discount deducted.

We are therefore returning your check to you, with the request that you let us have a remittance for the full amount of the bill in question.

Interest on Past-Due Accounts

Where a customer is permitted to take overtime on his account, he is in fact using borrowed capital rightfully belonging to the seller, to finance his business, for the use of which he is paying nothing. In order to overcome this injustice many houses have adopted the policy of charging interest on past-due accounts. There is no question as to the legality of such procedure, but in view of the fact that such a policy is followed by but a minority of merchants, it is proper, if not necessary, that this fact should be stated on all orders, invoices, and statements, or notice should be brought to the attention of the customers that the rule will be enforced.

The same principle should likewise apply to notes received from customers where an extension in time of payment has been granted. Such notes should always provide for the payment of the legal rate of interest for the extended period.

Shortage

There was a time when claims of shortage in shipments were a source of great annoyance and considerable expense to manufacturers, but this has largely been overcome by precautions in the nature of checking, taken at both ends of transit, thus shifting the burden of responsibility to the carrier.

Responsible houses now make it a practice to have every shipment checked in such a way as to enable them to submit an affidavit as to the contents and an effective way of guarding against unfair claims of this nature is to attach to each invoice

a copy of the shipping list showing the contents of the package or shipment and calling attention to the fact that the list has been checked by at least two persons whose names or initials are signed to it. Such procedure simply serves as notice to the consignee that the shipper is prepared to resist an unfair claim. In event, however, that a shortage is claimed, it is expected of the buyer that he, too, is prepared to substantiate his claim with a similar document. These affidavits are then submitted to the carrier as proof that the shortage occurred in transit. This policy has also served to put carriers on guard, and has resulted in a careful checking all along the line, and, consequently, a material reduction in the number of shortage claims. Claims for damage to goods in transit are handled in like manner.

As between the parties to a sale, the terms of sale determine whether the burden of following up a shortage rests with the buyer or seller. If the goods were sold "freight prepaid," the responsibility of the seller ceases when the goods are turned over to the carrier and a receipt, in the nature of a bill of lading, is obtained; if the goods were sold "delivered," the responsibility of the seller continues until the shipment is actually turned over to the buyer at destination.

Such claims present a splendid opportunity for the seller to render a further and greatly appreciated service to customers, and many of the larger manufacturers willingly assume the handling of such claims with the carrier on receiving the necessary data from the merchant. He may write to the buyer as follows:

> We are quite surprised to learn from your favor of the ...... that there was a shortage of 5 bbls. of soap chips in the shipment we consigned to you on ...., as a reference to the bill of lading shows the shipment to have consisted of 50 rather than 45 bbls.
>
> Inasmuch as our goods are sold "freight prepaid" and not "delivered," our actual responsibility ceases when we have

delivered the goods to the railroad company and obtained a signed bill of lading from them, showing the goods to have been received in good order; but our interest in the matter continues, however, until we know the shipment has been received by the buyer and in accordance with the order placed with us.

It is therefore the policy of our company to relieve our buyers of the trouble and annoyance of filing claims to cover such shortages, so we are enclosing an affidavit for you to execute covering the shortage in question, upon return of which we shall file your claim and follow the matter up closely until a satisfactory adjustment has been obtained.

Checks Marked "Payment of Account in Full"

Is a check given in payment and marked "In full of account" which does not as a matter of fact pay the entire account, payment in full; and is the payee who holds the check estopped from enforcing a claim for the uncovered balance? The general rule is as follows: If the claim is liquidated and there is absolutely no question as to the amount due, a check for a lesser amount than the claim, even though marked "In full of account," does not settle the account and the creditor may keep the check and sue for the balance. If, however, there is a dispute as to the amount of the claim and the same is not liquidated, a check sent "In full of account" amounts to an offer to settle the entire account for the amount specified in the check and the creditor must either return the check and sue for the amount claimed by him, or accept the check in full payment.

Another phase of this question has to do with checks that are sent in after the discount period is passed, with the discount deducted, and are marked "In full of account." Can such checks be properly deposited and claim be made for the amount of the discount? The answer is that they obviously fall under the above-mentioned rule, and claim can be made for the cash discount so deducted in cases where there is no dispute as to the terms. The practical effect of the matter is, however, that each single transaction is, in most instances of this character,

for a comparatively small sum for which it would be impractical to sue because of the incidental expense.[1]

Defects in Remittances

In the handling of collections, checks are frequently received containing a discrepancy between the amount specified in writing and the amount in figures. In such a case the credit man may either return the check for correction, or put an indorsement on the check guaranteeing it for whichever is the correct amount and deposit it for collection.

A credit man will often find in the mail a check from a slow customer, which is unsigned. In order to avoid any further delay in payment, he may arrange either to deposit the check for collection with the understanding that it is to be signed by the maker when it is received by the bank on which it is drawn, or he may deposit it with a sight draft attached, with the understanding that it is to be forwarded to the maker's bank for collection.

Assuming a check to be returned marked "Not Sufficient Funds," the credit man can possibly arrange to leave it with the bank on which it is drawn with an understanding that as soon as sufficient funds are deposited to cover the amount of the check, the bank will certify it and return it to the holder.

Or, where the account lacks but a few dollars of covering the check, he may follow the plan of one resourceful credit man, and deposit to the credit of the maker of the check sufficient of his own money to bring the account up to the required amount and then have the check certified.

Market Declines

Claims for market declines are confined almost exclusively to products sold on a fluctuating market and arise in this manner: A customer places an order with the house at a certain price and the goods are delivered accordingly. By the

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[1] See Credit Men's Manual of Commercial Laws, p. 216.

time the invoice covering the shipment falls due the market price of the goods has declined, and he remits on a basis of the present price, claiming that he should be given the benefit of the decrease.

There is of course no more justice in such a contention than there would be in the reverse situation, where on a rising market the manufacturer bills the customer at the advanced price rather than that at which the order was taken. The terms of sale are fixed when the business is booked and are not subject to change or alteration except by entering into a new agreement.

There is but one ground on which such claims can be justified, and that is when the salesman in booking the business guarantees the price of the goods against any market decline under so-called "G.A.D." contracts. In no other instance should such claims be allowed, and when a customer claims to be given such favors by other houses, he is simply branding himself as one who measures his commercial integrity and his general business reputation in terms of dollars and cents.

Returned Merchandise

The return of merchandise on the ground that the "goods are not as represented" generally connotes a lack of foresight on the part of the buyer in anticipating a market for the goods, and, having made an unprofitable purchase, he seeks this means of disposing of the unsold portion. Practiced to any great extent it would work quite a hardship on the manufacturers and also encourage promiscuous buying and careless selections on the part of the trade. So the policy of credit men should be to discourage it and refuse to relieve the merchant of such goods except for good and sufficient cause. One way in which this evil could be largely curtailed is through the general adoption of the trade acceptance (see Chapter XXV).

No Invoice

One of the many ruses practiced in mitigation of delay in payment and quite annoying to a credit man is for a customer, after having had the account brought to his attention several times, to write or return the draft sent to him with a notation that he has not received the invoice. To combat this evil the credit system should provide for all invoices returned for lack of correct or complete address, or any other reason, to be referred to the credit department for their information, and also to the bookkeeper handling the account, in order that he may also mark his records accordingly. There are several advantages in so doing: (1) it serves as a check on the billing department; (2) it leads to proper correction being made in the bookkeeper's records; and (3) it places the collector in a position to "come back" at the debtor in somewhat the following manner:

> We have your favor of .... (or, the bank has just returned the draft drawn to cover our charge of .... amounting to .... with a notation stating that you had no invoice covering the shipment) in reference to your account with us, stating you were unable to locate the invoice covering our charge of .... amounting to ....
>
> We are not only at a loss to understand why the matter was not previously brought to our attention, but furthermore cannot account for your failure to receive an invoice covering the shipment, as our goods are invariably billed the day shipment is made and we have no record whatever of the invoice in question having been returned.
>
> However, we gladly hand you a copy of the billing, and as the charge is now considerably past due, we trust arrangements will be made to favor us with an immediate remittance to cover.

Cancellation of Orders

There are two possibilities to be discussed in connection with canceled orders:

1. Cancellation of orders involving no change in the price of the goods.

2. Cancellation of orders where there has been a decline in the price of the goods since the order was placed and before delivery is made.

1. In such instances a due regard for the truth and a knowledge of the real situation compels the admission that an "order," so called, according to the custom of manufacturers almost universally prevailing, is nothing more than an option in favor of the buyer. It is cancelable by custom in event the buyer sees fit to cancel, because few sellers are willing to sue the buyer upon the order. Furthermore, the seller oftentimes has orders on his books received through his salesmen on which the buyer has been given to understand that he does not have to take the goods if he does not want them. Such an order can easily be revoked by the buyer in case he deems it to his advantage.

In such a situation the seller is compelled either to comply with the buyer's wishes and cancel the order, or refuse to do so and either force delivery of the goods, or sue for the damage or loss of profit caused by the refusal to accept the goods. In nine cases out of ten, however, the seller will choose the former alternative as the wiser course to pursue and trust to future business to offset his loss in this instance. In some lines of business a weakness has developed under the pressure of competition in the matter of assenting to cancellations rather than to risk incurring the displeasure of customers.

This is, of course, an unfortunate situation, for which both the manufacturer and the merchant are to blame, the former for countenancing such a practice, or for permitting his salesmen to place him in such a position that he is forced to countenance it, and the latter because of his manifest lack of respect for the moral, if not strictly legal, obligation involved.

Like other trade abuses that of canceling orders will also be eradicated in time through co-operative competition between the larger houses, and through a general elevation of the standards of doing business among the trade.

2. Suppose A, a butterine manufacturer, using a large quantity of cottonseed oil in the preparation of his product, enters into a contract with B in February for his June oil requirements, calling for 3 cars of oil, June delivery, at 85 cents a gallon. Between February and June the price of oil has dropped from 85 cents to 72 cents a gallon. B writes A on June 1 asking for shipping instructions on the 3 cars of oil which he contracted for in February at 85 cents a gallon, and A writes a very pleasant letter in reply in which he states his business has not been as good as he expected and he finds he has enough oil in stock to carry him through the month and consequently is not in a position to accept delivery of the 3 cars. What is B going to do about it? B has a profit of 13 cents a gallon on the 3 cars of oil but he cannot ship the oil, for A has told him that he does not intend to take it. The manner in which contracts of this nature, based on a fluctuating market, are handled is this. The 3 cars of oil, theoretically at least, have been set aside waiting shipping instructions from A, and when he refuses to accept delivery, the oil is sold on the open market at the prevailing market price (72 cents a gallon) and he is billed with the market difference of 13 cents a gallon, for which amount he can be held legally liable under the contract.

Unjust Claims

The reader should not be misled to think that each and every case presented represents a deliberate attempt on the part of a customer to take an unjust advantage of his creditor, for while this is frequently true, there are also instances when a customer is likewise convinced that the house is trying to take an unjust advantage of him, and in such instances it is the duty of the credit man to handle such claims in such a way as not to give offense to the trade.

Collectively, these trade abuses may be said to constitute the seamy side of the credit man's work, and it is in the han-

dling of such claims that the credit man is afforded an opportunity either to display tact and diplomacy by pleasantly and inoffensively pointing out and successfully maintaining his side of the controversy, or, through incapacity to cope with the problems presented, to manifest an antagonistic spirit which eventually proves costly to the house because of a loss of business.

Correction of Abuses

The correction of these various trade abuses rests primarily with the larger and more responsible houses whose brands and trade are well established, enabling them to assume and maintain an independent stand by refusing to tolerate such practices, and the most that can reasonably be expected of the smaller competitors is their co-operation in educating the trade to a realization of the injurious effect such practices have on both their business standing and credit responsibility so as to raise customers' standards of doing business.

The object should be to impress upon the offenders the true value and care that should be placed upon an established line of credit. They should be made to realize that their credit standing is a part of the character of their business, and that it is something which they can hardly afford to jeopardize by practicing any such abuses in the conduct of their business.

And finally the cardinal rule or principle that has been established as a guidance in the handling of all forms of trade abuses is: "Hold the customer and his good-will if possible, and yet protect the firm from unbusinesslike practices."

PART V

LEGAL RIGHTS AND REMEDIES OF MERCANTILE CREDITORS

CHAPTER XXIII

EFFECTING THE COLLECTION

Prompt Collections and Turnover

Prompt, or, as they are oftentimes referred to, "close" collections, constitute a vital feature of every business, because the business profits are largely dependent upon the number of times a merchant can turn over his invested capital. To illustrate this fact, let us assume a merchant doing business with a capital amounting to $100,000. The relationship of his turnover and gross profits may be shown as follows:

$100,000 turned over twice a year at 10 per cent yields a gross profit of $20,000 a year.
$100,000 turned over three times a year at 9 per cent yields a gross profit of $27,000 a year.
$100,000 turned over four times a year at 8 per cent yields a gross profit of $32,000 a year.

In other words, by diminishing his percentage of profit, and thereby enabling him to increase his capital turnover, one merchant can derive a greater profit from his business than another who insists upon realizing a larger percentage of profit on his sales and thereby restricts his capital turnover.

The number of times a merchant can turn over his working capital depends primarily on two equally important factors:

1. The rapidity with which he can market his goods.
2. The rapidity with which he collects the money in payment for the goods sold.

The first is purely a matter of salesmanship with which we are not directly concerned. The second depends largely, if

not entirely, upon the efficiency of the credit department in effecting the prompt payment for goods sold.

Other Consequences of Slow Collections

Although the close relation that exists between collections and the capital turnover may be said to constitute the most important reason for prompt collections, there are serious consequences of another nature which result from looseness or laxity in following up collections. These are as follows:

1. Slow collections have a very harmful influence on the volume of sales because, generally speaking, a debtor whose account is overdue will be tempted to patronize a competitor rather than incur the possible embarrassment of having his order either refused or held up until the back bills have been paid.

2. Prompt collections prevent the running up of a large overdue account and thus enables a concern to satisfy a greater need for their goods on a limited line of credit than is possible where the account is allowed to remain open after maturity.

To illustrate this point, let us assume, first, that a merchant to whom we have extended a $1,000 line of credit, and are selling goods on terms 30-2-10, discounts our bills as follows:

Sale	$1,000	goods on	1st	of month
Paid	980	" "	10th	" "
Sale	1,000	" "	11th	" "
Paid	980	" "	21st	" "
Sale	1,000	" "	22nd	" "

At this rate of payment sales could amount to $3,000 a month, or $36,000 a year.

Next, let us assume that he pays his bills promptly at maturity:

Sale	$1,000	goods on	1st	of month
Paid	1,000	" "	31st	" "

On this basis sales could amount to only $1,000 a month, or $12,000 a year.

Finally, let us assume that he is allowed to take 60 days in which to pay:

Sale $1,000 goods on 1st of month
Paid 1,000 at end of following month

Here sales could amount to but $6,000 a year.

3. Although it must be anything but pleasant for a debtor to be harassed by one's creditors, still his respect is commanded by prompt and efficient collection methods. Most debtors respect a house that watches its accounts closely, and the natural tendency is for them to pay the accounts of such a house more readily than those of a house which is known to be lax in following up its collections.

Following the Collection

Under this heading we are going to follow and discuss, first, the collection of an account from the time it falls due (after maturity an account automatically becomes a collection) to the point when it is placed in the hands of an attorney; and on through the levying of an execution on the debtor's property, which represents the culmination of the creditor's efforts, for if the debtor has sufficient property over and above the exemption the law allows him, to satisfy the claim, it will be attached and sold by a representative of the court, whereas if he has nothing over and above the exemption, the claim is returned as worthless (*nolle bonne*) and considered a "loss account."

The primary object of the collector is not simply "to get the money." What is often of even greater importance is to retain the debtor as a customer and hold his business, for obviously it is poor policy to hazard the loss of business aggregating $800 a month in the collection of a $300 account. The collector is consequently ever confronted with the dilemma—how to push a man for money without saying anything or taking any action which will offend him to such an extent that he will discontinue his custom. While at first the

two ends seem quite inconsistent, the dilemma not only *can* be solved but is *being* solved by efficient credit departments.

Stages in the Collection Process

In the first place, although there are few established rules to be followed in handling collections, each case presenting its individual problem, there are nevertheless certain well-defined stages through which the collection of an account may pass:

1. Stage of notification, in which the debtor is notified that the account is due, generally by a typewritten statement of the account, timed to arrive the day the account falls due.
2. Stage of reminder, in which the account is again brought to the debtor's attention by means of a letter attributing the delay in payment to some oversight.
3. Stage of discussion, in which it is assumed that there is some special reason for the delay and the creditor not only wishes to ascertain the cause but also to impress upon the customer that the seller is not justified in allowing additional time on his bills.
4. Stage of necessity, in which the creditor refuses to permit the account to run any longer and states his intention to adopt more radical measures in event it is not paid immediately.
5. Stage of compulsion, where the account is placed with an attorney or collection agency to force payment.

It is not meant by the foregoing that the collection of every account passes through each and every one of these stages. The circumstances may, for example, be such as to justify placing an account in the attorney's hands without any discussion whatever as to the reason for the delay in settlement, but they represent all the possible steps which may be taken by the collector. The degree of aggressiveness with which the debtor should be approached will depend upon (1) the nature of the account, (2) the value of the business, and (3) the length of time he has been trading with the merchant. Thus a knowledge

of his credit standing, or a history of the account, so to speak, is absolutely essential to the intelligent handling of the collection.

Throughout the first three stages the tenor of the correspondence is not only that he *should* pay but that he also *intends* to pay. In other words, the presumption is in favor of the debtor in much the same spirit as "a man is legally presumed to be innocent until proven guilty." Once convinced, however, that he does not intend to pay until compelled to, the collector has arrived at the fourth stage when "diplomatic relations are severed," so to speak, and the attitude assumed by him in subsequent correspondence is that the debtor *must* pay, as shown first by the collector's intention to adopt more radical measures and finally by threatening to place the account in the attorney's hands.

Manner in Which the Transition Is Accomplished

In the following discussion concrete examples of letters will be used to illustrate the spirit in which the transition from one stage to another should be accomplished in the collection of an account.

1. Notification. This generally consists of a typewritten statement, timed to arrive the day the account falls due, and serving to bring the account to the debtor's attention in event it has been overlooked. The process is mechanical and the notice is almost always sent out by the bookkeeper handling the account.

2. Reminder. There being nothing distinctive or personal about a typewritten statement to command special recognition, the account is next brought to the debtor's attention by means of a short letter courteously referring him to the account and attributing the delay to some oversight:

> We notice upon referring to your account with us that we have not as yet been favored with a remittance in settlement of our invoice of .... amounting to ....,

and attributing the delay to some oversight in your office, we deemed it advisable to bring the matter to your attention.

We recently sent you a statement calling attention to our invoice of .... amounting to .... but we do not find that we have as yet been favored with a remittance to cover.

While we have no doubt that the matter has simply been overlooked, the charge is now somewhat past due, so we therefore trust the account will be placed in line for early payment.

3. Discussion. The account having been brought to the debtor's attention several times before, it can be safely presumed that the delay in payment is not due to an oversight, and there must be some other reason for it. Either he is purposely delaying payment to gain additional time, or he is not in a position to pay. So a longer letter is used to impress upon him the fact that the collector is not justified in allowing additional time on his bills and endeavoring to elicit a response from him in explanation of the delay as a basis for further action:

On referring to your account with us we find that we are still without a remittance in settlement of our invoice of .... amounting to .... although the matter has been brought to your attention on several occasions, and as we have heard nothing from you in this connection, we are consequently at a loss to understand the delay in payment.

Inasmuch as the price of our products is based on our regular terms of payment, which as you know are limited to strictly .... days net, we are not justified in allowing additional time on our bills, and as the charge in question is now .... days past due, we must ask that the matter be given proper attention.

We wrote you on .... in connection with your account with us, calling attention to our invoice of .... amounting to .... but we cannot find that you have either complied with our request for a remittance to cover, or written us in explanation of the delay in settlement.

> Our terms of payment on .... are strictly ...... days net and the conditions under which this product is sold do not justify allowing additional time on our bills.
>
> The charge referred to is now ...... days past due, so we therefore wish to again request that the matter be given proper attention and we trust arrangements will be made to favor us with a prompt remittance to cover.

Some firms make a practice of injecting a little sales talk into their correspondence in the first three stages of collection as suggestive of the value of continuing their pleasant business relations, and by way of anticipating an early settlement and further business. There is only one objection to this. It undoubtedly weakens the appeal by dividing the recipient's attention. But the appeal up to and including the third stage is precatory rather than mandatory. So perhaps this is not such a serious objection after all.

4. Necessity. Once convinced that it is the intention of the debtor to delay payment as long as possible, no time should be lost in impressing upon him the fact that he not only should, but must pay:

> We wrote you on .... and again under date of .... calling attention to our open charge of .... amounting to .... and requested that the matter be given proper attention, but we cannot find that a remittance for this amount has been received. As we have heard nothing from you in this connection, we are not only at a loss to understand the situation but have about come to the conclusion that the matter is one requiring more radical collection measures.
>
> While we dislike very much to take any action that would necessarily cause you annoyance or embrarassment, we feel that we have been very liberal with you in this connection, as the charge is now over ...... days past due.
>
> We must, thefore, insist upon the account being given immediate attention, for we wish to state quite frankly that unless a remittance in full settlement is received by return mail, we shall consider it necessary to adopt other collection measures for the proper protection of our interests.

Although the matter has been brought to your attention on no less than .... occasions we find we are still without a remittance in settlement of our invoice of .... amounting to .... and as we have not been favored with even the courtesy of a reply to our correspondence in this connection, giving us any explanation as to the delay in payment, we have about come to the conclusion that the matter is one requiring the further attention of our attorneys.

While we dislike very much having to write you in this manner, you must appreciate that we have been very considerate with you, as the charge referred to is now over ...... days past due.

We therefore feel constrained to state, and we must also ask you to consider this final, that unless a remittance of the full amount involved is received by return mail, it is our intention to place the account in the hands of our attorneys.

5. Compulsion. This brings us to the final stage in the collection correspondence, and once the account is referred to an attorney the collector no longer deals direct with the debtor. But if the amount involved is quite large and the account one in which you are particularly interested, it is oftentimes a good policy to advise the debtor of the action being taken and thus afford him a final opportunity to effect a direct settlement:

We are sorry to find that you have not complied with our final request for a remittance of .... in settlement of our invoice of ...., so we are accordingly placing the account in the hands of our attorneys today with instructions to take any action they may deem most expedient to the proper protection of our interests.

Although we feel quite justified in taking such action, we would at the same time greatly prefer effecting an amicable adjustment of the amount involved. So if you will let us have a remittance in full settlement by return mail, we will gladly instruct our attorneys to return the claim without taking any further action.

The adoption of legal measures with a view to forcing payment necessarily has a very injurious effect on a concern's business standing, so for your own good we hope you will take advantage of this final opportunity to adjust the account with us direct.

Varying Degrees of Strength in the Tenor of the Appeal

That the collector is given a wide latitude in voicing his appeal for payment may be satisfactorily illustrated by means of a few well-chosen words or phrases characteristic of the different degrees of strength that may be manifested in the tenor of his correspondence:

1. "Merely wish to bring the matter to your attention."
2. "Wish to again call attention to the fact that our invoice of.........has not been paid and ask that the matter to be given proper attention." (Note that no direct request for payment has as yet been made.)
3. Ask for an "early" remittance to cover.
4. Ask for a "prompt" remittance to cover.
5. Insist upon an "immediate" remittance to cover.
6. Insist upon a "remittance by return mail."
7. "Unless a remittance is received by return mail, we shall feel compelled to adopt other collection measures."
8. "Unless a remittance is received by return mail, we shall feel compelled to adopt more radical, more stringent, or more drastic collection measures for the proper protection of our interests."
9. Threaten to place the account in the hands of an attorney.

Characteristics of a Successful Collection System

It might be well to point out a few characteristics which may be considered essential to every successful collection system:

1. Your correspondence must always, even in the final stages, be courteous and dignified for the prestige of your house, as adhering to high standards in all its methods from the time the sale is made to the time of its liquidation, no matter what the circumstances which may arise during that period, must be upheld and respected. Hard lines or roughshod methods will have a lesser force for good than mildness and clemency.

The cheapest thing in the world is courtesy, and it brings a larger volume of profit than any other factor in merchandising. Some business men think that this applies only to the salesman who comes in personal touch with the customer, but this is not the case. Instances are numerous where a little courtesy shown in the tone of a letter has made a good customer. Cases are even more numerous where a discourteous letter has resulted in the loss of profitable business. It is utterly impossible to avoid entirely disagreements with customers, but a disagreement properly and courteously handled does not necessarily mean the loss of that customer's business. But if it is not handled properly, not only is the customer lost, but he is aggrieved and is very likely to spread broadcast that the firm is not treating its customers fairly. A reputation of that kind will naturally make it more difficult for salesmen to get business. In order to avoid such a reputation, it is not necessary to be weak-kneed and allow every claim made by a customer. Courtesy and tact are a necessary part of successful collection correspondence.

2. It is neither necessary nor good business policy to offer an excuse for requesting payment, for you are not in the position of one asking a favor, and it obviously reflects on your financial strength to show an urgent need of funds. In fact, the credit man should avoid most diplomatically any semblance of timidity in requesting payment.

3. To be efficient, the collection system must be prompt and flexible. By being prompt in the collection of your accounts you show the debtor that his account is being carefully watched and such efficiency, while sometimes annoying, never fails to command respect. Furthermore, prompt and close collections keep the finances of your firm in a more healthy condition, and reduce the amount of working capital necessary to run the business.

4. The system must also be susceptible to variation according to the nature of the accounts, as the severity with

which payment is requested is a matter of discretion and judgment of the correspondent, depending on the responsibility of the debtor, the value of the business, and the length of time he has been trading with you.

A discussion of the draft in this connection has been purposely omitted for the reason that drafts are used differently by different concerns and the policy also varies with the various lines of business. Some firms make a practice of drawing on their customers 10 days after maturity, whereas others reserve this as a last resort prior to placing the account in the attorney's hands.

Dunning by Wire

There are no legal restrictions which forbid the dunning of a debtor by telegraph, provided proper precaution is taken in the wording of the wire, i.e., a mere inquiry as to when a remittance may be expected. Any words, however, tending to convey the impression or inference that the debtor is a fraud, or a cheat, or that he unnecessarily or without cause delays the payment of his accounts might subject the sender to an action for libel.

CHAPTER XXIV

LEGAL PROCESS

Credit Men and the Attorney

A well-known writer on the subject once said:

> The grievance of the credit man against the lawyer is that he won't work for nothing, and the grievance of the lawyer against the credit man is that he expects something which may save him thousands, and which is something of the lawyer's stock in trade, for nothing. The credit man usually knows little about law, and the lawyer little or nothing about business, and when oil and water mix, we may expect a satisfactory result from two such forces.

There seems to be a more or less common impression among credit men that something mysterious takes place after an account is turned over to an attorney, which is beyond the comprehension of anyone but an attorney, and the lack of knowledge on the part of many credit men as to just what does transpire in the subsequent proceedings is not only surprising but a great mistake on their part, because there is absolutely no reason why anyone of sufficient intelligence to handle collections should not be just as familiar with the process of forcing a settlement as an attorney. The usual procedure to be complied with involves very little law, and practically no legal reasoning, and for the most part constitutes a mere matter of formal procedure.

It is a mistake for a credit man to assume that in turning an account over to an attorney he is through with it entirely, and thus shift over to the attorney the responsibility of deciding what action is advisable. In other words, it is unreasonable to expect a lawyer to act as credit man, and the most that

can reasonably be expected of him is information and advice as to the credit man's legal rights coupled with the desire and capacity to carry out his instructions. There are times when a credit man must have the assistance of an attorney, and the attorney in handling such business is, in turn, dependent upon the credit man for his information and instructions, simply because the credit man is more familiar with the debtor's affairs. So in order to be productive of the best results, the relation between the two should be based on the co-operative principle—let each attend to the part he can handle to greatest advantage, and let the credit man never lose sight of the fact that he can reasonably expect attorney services only commensurate with the fee the attorney is to receive for such service.

Law Lists of Bonded Attorneys

In most states there are attorneys who make a specialty of handling the collection of commercial accounts and whose names are to be found in one of the numerous law lists, or "Directories of Bonded Attorneys," published by the various agencies throughout the country and at all times available to credit men.

The collection fees for handling such claims are usually fixed and published in the directory, together with a guaranty of the publisher of the list insuring the prompt payment to the creditor of all money collected by any attorney listed in their directory, provided the prescribed notice is given as to when and to whom the claim is being sent. The only objectionable feature to such service as contrasted with that of the various forwarding agencies, e.g., the Credit Clearing House and others, is that it does not relieve the creditor of the burden of following up the work of the attorney to whom the claim is entrusted in order to satisfy himself that the account is receiving the attention which it requires in order to be properly handled.

Forcing a Settlement

Once an account has been placed in the hands of an attorney, all correspondence received from the debtor should be referred to him, as from this time on the attorney should be considered in full charge of the matter. Suppose, however, that, after advising the debtor that you have placed the account in the attorney's hands with instructions to force a settlement, he sends you a check for the full amount. Should you keep the check or refer it to the attorney? If suit has been filed the check should not be accepted, because it costs money to sue a man and the court costs which have been advanced will eventually have to be paid by the debtor in addition to the full amount of the account. By accepting the check under such circumstances you thereby assume the court costs. If, however, suit has not been filed, there is no reason why the check should not be accepted without referring it to the attorney, but never fail to advise the attorney accordingly in order to save him the embarrassment of attempting to force a settlement of an account which has been paid.

Demand for Settlement

Let us follow the process of collection from the time the account is received in the attorney's office.

Generally, the first thing he does is to advise the debtor, either by letter or through some local representative, that he has received the claim for collection, and to demand an immediate settlement on behalf of his clients.

Investigation

Assuming such a demand to be ineffective, the next step is to ascertain the true financial responsibility of the debtor in order to determine whether, in event suit is brought and a judgment obtained, the debtor would be good for the amount involved under an execution. If the prospects disclosed by the investigation seem doubtful, suit is postponed for the pres-

ent—nothing is to be gained by throwing good money after bad—and dunning measures, such as the drawing of drafts, threats of suit, bankruptcy procedure, and the like, continued.

If, however, the prospects of forcing a settlement appear favorable, suit is entered in the proper court, and the usual form of procedure thereafter in the prosecution of such a case in court is briefly as follows:

1. Bringing of the case and the parties into court.
2. Framing of an issue.
3. Hearing or trial.
4. Judgment.
5. Appeal.
6. Execution.
7. The return.

Suit

The word "suit" is incorrectly, although quite commonly, used to describe and characterize the legal procedure of a creditor to enforce the payment of his claim. The proper phrase as used among lawyers is "an action at law," the distinction being that the word "suit" is strictly applicable to a proceeding in equity as distinguished from an action at law.

Civil actions, such as those brought by a creditor against a debtor in the prosecution of his rights growing out of the sale of merchandise, are commenced by filing in the proper court (depending on the jurisdiction and size of the claim) a petition for judgment, on a form which in some states is very appropriately termed a "statement of claim" (Form 14) wherein the substance of the claim is set forth under oath in proper technical and legal form.

Where the claim is to be sued upon in a distant city the usual procedure is for the creditor, instead of certifying such a statement of claim, drawn up by his local attorney, to execute an "affidavit in proof of claim" (Form 15), which he then forwards to his attorney located in the city of the debtor.

THE STATE OF OHIO
Hamilton County } *ss.*
City of Cincinnati

IN THE MUNICIPAL COURT OF CINCINNATI

The Crocker & Bramble Distributing Co.
a corporation under the laws of Ohio } *Plaintiff*

vs.

Mary Volmer,
doing business as "Volmer's Home Bakery,"
located at No. 1492 Montgomery Road,
Cincinnati, Ohio } *Defendant*

No. . . . .
Claim for $92.20

STATEMENT OF CLAIM

Plaintiff's claim is upon an account, a copy of which with all credits thereon is as follows:

1922			
Oct. 27,	Lard Compound	$ 7.75	
Nov. 2,	"	15.50	
" 6,	"	7.75	
" 13,	"	15.50	
" 29,	"	15.50	
Dec. 6,	"	15.50	
" 13,	"	15.50	
			$93.00
Credit:			
Less cash discount not deducted			.80
Balance			$92.20

There is due plaintiff from defendant upon said account the sum of ninety-two and 20/100 dollars ($92.20), payment of which has been demanded but refused. WHEREFORE: Plaintiff prays for judgment against said defendant for $92.20 and for costs herein expended.

S. FARRAR LONG
Attorney for Plaintiff

Gwynn Building, Cincinnati, Ohio
Business Address

The State of Ohio
Hamilton County } *ss.*
City of Cincinnati

A. R. Sheffield, being first duly sworn, says

That he is Secretary of The Crocker & Bramble Distributing Co., plaintiff in the above entitled cause and that the facts set forth in the foregoing statement are true.

A. R. SHEFFIELD

Subscribed and sworn to before me this 17th day of February, 19__.

GUY B. FOSTER
Notary Public—Hamilton County, Ohio
My commission expires Oct. 23rd, 19__

Form 14. Statement of Claim

AFFIDAVIT IN PROOF OF CLAIM

STATE OF OHIO....*Hamilton*....COUNTY, ss.

The undersigned ....*A. R. Sheffield*.......... being first duly sworn, on oath states that he is[1] ......*Secretary of The Crocker & Bramble Distributing Co.—a corporation organized and doing business under the laws of the State of Ohio*...... the owner.. of the claim against ......*Mary Volmer, doing business as "Volmer's Home Bakery" at 1492 Montgomery Road, Cincinnati, Ohio*...... hereto attached and made part hereof; that the same and every item thereof is lawful and justly due; that the consideration therefor is[2] ......*goods and merchandise sold and delivered on open account by said claimant to said debtor at their special request, as per statement attached*...... that there is now due and unpaid on said claim the sum of ......*ninety-two and* ---------------------------- $\frac{20}{100}$ Dollars, ($92.20) with interest thereon at the rate of .... per cent. per annum ....

....

.... from the ....*13*.... day of ....*January*...., 192__...; that there are no payments on said claim in the way of discounts or otherwise; that there are no set offs nor counter-claims whatever against the same[3] ....
that there is no usury therein; that said owner has........ no collateral, personal, or other security whatever for the same.

(Affiant)............*A. R. Sheffield*.............

Sworn to before me and subscribed in my presence this ....*17*.... day of ....*February*...., 192__...

....

(SEAL.) ....*Guy B. Foster*..............
...*Notary Public—Hamilton County, Ohio*...

Affidavit..-----..cents. Paid by..-----..
....*My commission expires Oct. 23, 192*__...

[1] If the affiant is the sole owner of the claim, leave space blank; if not the sole owner, fill out as the facts may be, as "a member of the firm of A. B. & Co., consisting of" (give the full name of each member of the firm), or "Treasurer of The .... Company, a corporation under the laws of ...."

[2] Fill out, as the facts may be, as "goods and merchandise sold and delivered," "labor done and performed," "professional services rendered as physician," etc.

[3] If there are, fill out "except as set forth in the attached claim."

Form 15. Affidavit in Proof of Claim

The sole reason for this variation in procedure is one of convenience, inasmuch as blank proofs of claim, a supply of which is usually to be found in every credit department, may be ob-

tained from any law stationer, and forwarded to the attorney at the creditor's convenience.

The distinction is to be noted between such an affidavit in proof of claim and the prescribed bankruptcy affidavit in proof of debt, because whereas the former may be executed by any officer of the corporation, the latter must be executed by the treasurer, or the officer whose duties most closely correspond with the usual and customary duties of a treasurer.

Thus, is an action at law instituted by the creditor, or plaintiff, in the proper court for the collection of a debt, a formal complaint or declaration of his cause of action is made. A summons to appear and make answer to this complaint is then served on the debtor, or defendant. (See Form 16.)

If the defendant cannot be found within the jurisdiction of the court, methods are provided whereby any property of his located within the state may be attached and subjected to the payment of his debts. (See "Attachment," Chapter XXV.)

SUMMONS

MUNICIPAL COURT—CITY OF CINCINNATI, COUNTY OF HAMILTON,
STATE OF OHIO

The Crocker & Bramble Distributing Co.
Plaintiff,
against
Mary Volmer,
doing business as "Volmer's Home Bakery"
Defendant.
} *Summons.*

To the above named Defendant:

YOU ARE HEREBY SUMMONED to answer the complaint in this action, and to serve a copy of your answer on the Plaintiff's Attorney within twenty days after the service of this summons, exclusive of the day of service, and in case of your failure to appear, or answer, Judgment will be taken against you by default for the relief demanded in the complaint.

S. FARRAR LONG,
Plaintiff's Attorney.

Dated, Cincinnati, February 18, 192__.
Post-Office Address and Office, Gwynn Building, Cincinnati, O.

Form 16. Summons Served on Debtor

Framing an Issue

Then follow the various pleadings which may be interposed by the parties until a definite issue of fact is arrived at. The pleadings are:

1. Declaration, or complaint by the plaintiff.
2. Plea, or answer by the defendant.
3. Replication, or reply by the plaintiff.
4. Rejoinder by the defendant.

Beyond these the pleadings seldom extend further. Upon these documents, or others which may be allowed, the issue is framed, that is, the question in dispute is made clear.

Issue having been joined, the case is then listed for trial, or docketed, on the trial calendar.

Trial

When the time set for the trial arrives, unless there is some special defense for non-payment to be interposed in the nature of a "set-off," or "counterclaim," the debtor generally permits judgment to be taken against him by default, for failure to answer, meaning that he simply does not put in an appearance in court, either personally or represented by an attorney to contest the claim. This judgment is simply the decision of the court upon the issue raised by the pleadings.

If, however, the case is to be contested by the debtor, whatever questions of law arise during the course of the trial are decided by the court. Questions of fact arising, however, are decided by the jury. The right to a jury trial may, however, be waived by the parties, and the costs of the action thereby curtailed. In most jurisdictions if the amount involved is less than $20, a party is not entitled to demand a jury trial.

Both parties are then afforded an opportunity to submit whatever evidence they wish to offer in support of their side of the controversy, and the burden of proof rests upon the plaintiff to prove his case by a preponderance of the evidence submitted.

If the jury or court, as the case may be, finds for the plaintiff, judgment is entered accordingly.

The Judgment

Such a judgment is theoretically the end of the action. But it recognizes no liens, and awards no execution against specific property. It contains simply the conclusion of the law upon the facts as set forth in the complaint, and leaves the judgment creditor to his legal and appropriate writ to enforce it. In other words, such a judgment is not of the self-executory kind.

Upon being docketed, however, the judgment becomes a lien upon whatever real estate the debtor may own within the county in which it was rendered. If the real estate is located in a different county within the state, a copy of the judgment must also be docketed in that county to create a lien on the realty.

Appeal

The defeated party may, however, appeal from the judgment. If he decides to do so, his attorney prepares a transcript of the evidence, and with this, after giving notice to his adversary, goes before an appellate court of judges and asks to have the judgment reversed. Argument on both sides is heard by the appellate court, and if the court finds a substantial error, or that the judgment is unsupported by the evidence, it may reverse the judgment and order a new trial. Otherwise it affirms the judgment.

The phrase "judgment is reversed" is misleading in that it does not really constitute a reversal of the judgment. For example, A sues B and obtains a judgment. The case is appealed by B, and the judgment is reversed. This does not mean that the court is thereby deciding that B does not owe A, but rather that some prejudicial error was committed in the proceedings in the lower court, which entitles B to a new

trial, wherein such error will not be repeated. In other words, instead of actually reversing the judgment, it merely serves to set it aside and thus render it unenforcible.

Execution

After the judgment is obtained, the law in most jurisdictions allows the defendant a certain length of time in which to settle in court the claim or judgment, including the court costs, and when this time has expired it is the privilege of the attorney for the plaintiff to request the issuance of a writ of *fieri facias,* commonly referred to commercially as a "writ of execution," which is a warrant directing some subordinate officer of the court, usually the sheriff, "to cause to be made" the amount of the judgment out of the personal property, goods, and chattels of the debtor by seizing all or sufficient property of the debtor over and above that which the law allows him as exempt from execution (the amount of which varies in the different states), to satisfy the claim and cover the court costs. Such seized property is then advertised for sale in accordance with the prescribed legal requirements and later disposed of at a public sale.

Where the realty is situated in a different county within the state than that in which the judgment was obtained, it is necessary to docket a copy of the judgment in the county in which the realty is situated before execution may be levied upon it.

Rights of Purchaser Arising Out of Sales on Execution

Property conveyed in fraud of creditors may be seized in the hands of the fraudulent grantee as though no conveyance had been made, and sold on execution as the property of the grantor. It therefore follows that the execution purchaser obtains a perfect legal title, subject to the burden of proving the conveyance fraudulent in event the grantee asserts its validity.

Rights of Execution Creditor Purchasing at His Own Sale

It is well-settled law that a third person purchasing property at a sheriff's sale, innocently and without knowledge of any defects in the title of the property, takes free of all equities. Does the same rule apply to a judgment creditor?

It has been held that a judgment creditor buying without notice at his own sale is not a purchaser for value. But this position seems questionable. The creditor may, it is true, pass over no money on his bid, but as a consequence of the transaction he does release his judgment claim. The result is in no way different from that which would have been reached had he paid cash to the sheriff and received it back in satisfaction of the judgment. Following this reasoning, some courts have held that the judgment creditor purchasing in good faith at the execution sale acquires a clear title.

This principle was also upheld in a case in which the defendant attached certain land, and at the execution sale bought the land himself. Prior to the attachment the land had been conveyed to the plaintiff by an unrecorded deed. The court held that the defendant under such circumstances takes clear of the plaintiff's equity.

The Return

In event the sheriff is unable to locate any assets on which to levy, he makes his return as having found the debtor execution-proof, and there remains but one course to pursue—arrange to investigate the debtor's affairs every 6 months in the hope that he has prospered sufficiently in the meantime to justify serving another writ of execution.

Loss Accounts

It is a great mistake to destroy a claim as worthless because the debtor has been found execution-proof. The author has collected many such claims in full with interest (the law allows interest on judgments until paid), or has succeeded in

effecting a partial settlement four or five years after the claim had first been returned as worthless. To follow them up until outlawed by the Statute of Limitations on Judgments is not only a profitable policy to pursue, but the moral effect in holding such debtors to their obligations, if practiced extensively, would undoubtedly be very effective and beneficial from a business standpoint. Accurate, complete, and carefully kept loss records in ledger or account form should constitute a part of the records of every up-to-date credit department.

Statute of Limitations

The common law sets no limit to a plaintiff's right to bring suit upon a claim or for a breach of contract, but every state in the union has enacted a statute limiting the period within which such action may be begun. This law is called the "Statute of Limitations." However, such statutes affect only the plaintiff's, or creditor's, remedy and not his right of action. The debt, in so far as the moral obligation is concerned, persists and continues even after the statute has run, but the payment of it has been rendered unenforcible at law. In other words the statute does not operate to cancel the debt, but merely to withdraw the remedy.

In the case of simple contracts the time limit fixed by the statutes is usually from three to eight years. For notes and judgments the period is usually longer. It varies somewhat in the various states, so that the state statutes must always be consulted to determine whether or not one's rights under a contract are barred by statute. As a rule, the statute runs from the date of the last payment, if the full amount of the claim is due at that time.

When the prescribed period within which such actions must be brought has elapsed, the contract, or right of action upon it, is said to be "outlawed," meaning that as a result of his delay in prosecuting his legal rights within the specified time the plaintiff has lost whatever right to prosecute he may have had.

There are four special circumstances, however, which may be said to "take the case out of the statute," meaning that they constitute exceptions to which the statute does not apply. They are:

1. The payment of interest.
2. Part payment of the principal.
3. A new promise to pay in writing.
4. A written acknowledgment of the indebtedness.

Part Payment and the Statute of Limitations

There is a distinct advantage in accepting or effecting part payment from time to time, to apply on past-due accounts, because such payments constitute an acknowledgment that the debt is due and strengthens a creditor's position legally, as the Statute of Limitations on open accounts begins to run from the date of the last payment on account, instead of from the date on which the indebtedness was originally incurred. This means that by accepting part payments from time to time the creditor extends the time within which he may enforce payment of the account before it becomes outlawed by the statute.

For clearness, let us suppose an imaginary case. Suppose on October 1, 1915, A's account with you showed a matured indebtedness of $500, and you withdrew his line of credit. Investigation proved his affairs to be in such bad shape that suit on the claim was inadvisable. Then let us further assume that he continued in business for 7 years in approximately the same condition, never seeming sufficiently prosperous to justify suit being brought, and that you made no effort to effect a part payment on the account. On October 1, 1921, the claim is outlawed (assuming statute to be 6 years). Your loss was $500 plus interest at 6 per cent, or a total of $680.

Next, let us suppose that on December 1, 1918, when the prospects seemed favorable for A to get back on his feet, you succeeded by threats of suit, bankruptcy, etc., in wheedling a payment on account of $50 out of him, and by 1923 he was

again on his feet. The statute, dating from the time of his part payment in December, 1918, had a year to run, so that you were in a position to force payment of the remaining $450, with the legal rate of interest which the law allows on past-due accounts. This payment would be figured as follows:

October 1, 1915—Matured indebtedness....................	$500
December 1, 1918—Part payment..........................	50
(Statute thereby extended from October, 1921, to December, 1924.)	
December 1, 1923, balance of $450 plus interest at 6 per cent.	660
Loss..	$716

If it had not been for the part payment of $50 in 1918 your claim would have become outlawed in 1921, with an incidental loss of $500 plus interest, or $680.

Instances of this nature are not so rare as may be supposed, and it simply illustrates the importance of a credit man being familiar with the little ins and outs of the game, which make for efficiency in his work.

A debt may also be revived by a new promise to pay it after it is barred by the Statute of Limitations. Almost all the states require such a promise to be in writing.

Supplementary Proceedings

The situation with which supplementary proceedings has to deal is of somewhat this nature. Suppose you have a claim against a debtor, and at the time suit is brought he apparently has ample assets out of which to satisfy your judgment. But after having reduced your claim to judgment, he is found to have dispossessed himself of all such available assets and rendered himself execution-proof. Under such circumstances suspicion would naturally attach to the manner in which the assets were transferred to some third party; or if sold, as to the disposition of the proceeds from the sale.

Of course, the debtor is not going to disclose voluntarily to you or your attorney anything he does not want you to

know. And yet, under the circumstances you have as a matter of justice a right to know something about the transfer of his property in order to satisfy yourself that there was nothing fraudulent connected with it, particulary in view of the fact that the primary object of the law is to promote justice by compelling men to perform and carry out their just and honest obligations to one another. The law gives a judgment creditor such a right by providing an opportunity for him to examine the debtor under oath in what are known as "supplementary proceedings," meaning, of course, proceedings supplementary to the judgment obtained.

Purpose of Supplementary Proceedings

The purpose, then, of supplementary proceedings is to afford a judgment creditor the right and opportunity to examine the judgment debtor, or any person indebted to the judgment debtor, for any property belonging to him, and also to provide for the application of such discovered property or debt to the payment or satisfaction of the judgment.

This two-fold purpose can be accomplished in either of two ways:

1. By the appointment of a receive.
2. By an order of the court directing the surrender or delivery of the property to the sheriff.

In other words, the purpose of the proceeding is similar in nature to the examination of a bankrupt in bankruptcy proceedings. However, in order to be entitled to such an order for the examination of the judgment debtor, or person indebted to him, an execution must have first been issued and returned unsatisfied. Thereafter, the right may be exercised at any time within the statutory period—usually 10 years.

Creditor Entitled to One Examination Only

The creditor has a right to only one examination of the judgment debtor or third person indebted to the judgment

debtor, in supplementary proceedings. But he may later apply to the court for a subsequent order or orders, which will be granted whenever he can show facts that have developed subsequent to the first examination, which in the opinion of the court warrant a second or further examination.

In event the judgment debtor, or third person, fails to appear in response to such a court order, he may be declared in contempt of court and punished accordingly.

Life Insurance Policies

As a rule, one of the first inquiries made of the judgment debtor in supplementary proceedings is whether or not he carries any life insurance. The reason for this is that while ordinarily the right of a beneficiary of an insurance policy is a vested right, if there is a reservation in the policy giving the insured the right to change the beneficiary, a judgment creditor of the insured may recover the surrender value of the policy.

An exception to this general rule is where the beneficiary is the wife of the insured, in which case she is generally entitled to an amount equal to the amount of insurance that could have been carried by the insured for a premium not exceeding a certain fixed sum ($500 in New York). In other words, you can have an execution running against a debtor's life insurance.

Circumstances under Which the Right May be Exercised

The right to examine a debtor in supplementary proceedings for the purpose of having his property applied in satisfaction of a judgment may be exercised at law to enforce the collection of any money judgment except in the following:

1. To apply property exempt by law from levy and sale under execution.
2. To apply trust property held for the benefit of the judgment debtor, but proceeding from another person.

3. Ordinarily, 60 days' earnings, when such earnings are necessary for the support of his family.

In all other cases, the judgment debtor, or third person charged with being his debtor or bailee, is directed by the order to appear before the court or referee at the time and place specified, and to submit to an examination concerning the property of the judgment debtor, who thereupon may be enjoined from transferring or otherwise disposing of it until authorized by the court.

Upon the return day of the order, the judgment debtor or third party so summoned is sworn by the judge or referee and questioned by the judgment creditor's attorney. The testimony is taken down, and when completed must be signed by the witness and sworn to before the judge or referee.

Remedy Is Statutory

Here again the remedy is one which is entirely statutory, and such remedy exists only where the state statutes so provide for it; but it is a remedy which has been provided for in most states, although the precise nature of the proceeding is not always uniform.

Exemptions

In every state a law has been enacted exempting a certain amount of a debtor's property from all liability for his debts, which shall not be taken on attachment or execution. The purpose of the law is to prevent people from being deprived of their means of earning a livelihood, and reduced to poverty, thus becoming a charge on the community. Some of the statutes enumerate the articles exempted quite minutely, such as the necessary furniture, needful clothing, schoolbooks, a certain amount of food and fuel, the tools of a trade, etc., and then add that other necessary articles not exceeding a certain amount in value are also exempted.

In most of the states a small homestead is protected from

creditors and exempted from attachment or execution. Various provisions are made in the different states to combine a due protection of the creditor with proper prevention of fraud. The most common means adopted is that of requiring that the homestead should be distinctly defined and set apart, and in many cases by the additional requirement that the description and location of it should be put on public record.

The significance of the exemption laws to a credit man is that it is necessary for a creditor to know what legal exemptions the debtor is entitled to, for the true net worth of the debtor's estate is correspondingly reduced to the extent of the exemption. In considering financial statements of merchants of limited financial responsibility it is especially important to know just what part of the assets may be exempted from creditors' claims by the state law. The following summary of the main items of exemption which prevail in the different states is given:

Alabama
- Homestead: 160 acres, value $2,000.
- Personal Property: $1,000.
- Wages up to $25 a month.

Arizona
- Homestead: $4,000.
- Stock in Trade: $400.
- Life Insurance: $10,000.
- One-half man's salary for 30 days.

Arkansas
- Realty: 60 acres in country, value $2,500; 1 acre in city, value $2,500.
- Household Belongings: $200.
- Other Personalty: $500.

California
- Homestead: $5,000, if head of family; $1,000, if any other person.
- Household Belongings: $200.
- Personal Property or Stock in Trade: $1,000.
- Wages for 30 days preceding levy.
- Life insurance on which premium does not exceed $500.

COLORADO

Homestead: $2,000.
Household Furniture: $100.
Tools, Implements, or Stock in Trade: $200.
Wages: 60 per cent over and above $5 a week.

CONNECTICUT

Homestead: $1,000.
Household Furniture: $150.
Business Equipment: $250.
Wages to amount of $25.

DELAWARE

No real estate.
Tools, Fixtures, or Stock in Trade: $75.
Head of Family: $200 additional.
(Exemptions vary in different counties.)

DISTRICT OF COLUMBIA

No real estate.
Household belongings: $300.
Tools, Implements, or Stock in Trade: $200.
Pictures, Books, and other Personal Property: $400.
Wages of head of family, not to exceed $100 a month for previous 60 days.

FLORIDA

Realty: 160 acres and improvements in country, ½ acre in city with improvements.
Personal Property: $1,000 (only to head of family).
All wages due.

GEORGIA

Aggregate real and personal property: $1,600.
Wages up to $1.25 a day, and 50 per cent thereover.

IDAHO

Homestead: $1,000 for single man, and $5,000 for family.
Household Belongings: $300.
Tools, Implements or Stock in Trade: $500.
75 per cent of earnings for preceding 30 days, not to exceed $100.

ILLINOIS

Homestead: $1,000.
Personal Property: $100.
Head of family: An additional $300 if selected property.
Wages not exceeding $15 a week.

INDIANA

Real and Personal Property: $600.

Wages up to $25.

IOWA

Real Estate: 46 acres in country, and ½ acre in city.

Household Belongings: $200.

Earnings for 90 days preceding levy.

KANSAS

Real Estate: 160 acres in country, with improvements, and 1 acre in city, with improvements.

Household Furniture: $500.

Tools, Implements, Stock in Trade: $400.

Wages: All but 10 per cent for preceding 3 months if necessary for support of family.

KENTUCKY

Real Estate: $1,000.

Tools, Equipment, etc.: $100.

Furniture, etc.: Sufficient for family use.

90 per cent of salary or wages not to exceed $75, otherwise $67.50.

LOUISIANA

Real Estate: 160 acres, whether rural or urban, and improvements.

Implements, Tools, or Stock in Trade: $2,000.

All wages.

MAINE

Realty: $500.

Furniture: $100.

Tools, Implements: $50.

Library: $150.

Life Insurance: Premium not to exceed $150.

Wages for 30 days preceding levy not to exceed $20.

MARYLAND

Property: $100.

In addition thereto, all wearing apparel, books, and tools.

Wages not to exceed $100.

MASSACHUSETTS

Homestead: $800.

Household Belongings: $300.

Tools, Implements, or Stock in Trade: $100.

Wages not to exceed $20.

MICHIGAN
- Realty: 40 acres in country and not to exceed $1,500 in city.
- Household Furniture: $250.
- Stock in Trade, etc.: $250.
- Wages up to $25.

MINNESOTA
- Realty: 80 acres in country, and ¼–½ acre in city.
- Household Furniture: $500.
- Tools, Implements, Stock in Trade: $400.
- Wages not to exceed $35, if earned within 30 days preceding.

MISSISSIPPI
- Homestead: $2,000 ($3,000 if by formal declaration).
- Tools, Implements, etc.: $500.
- Household Furniture: $250.
- Wages: $50 a month.
- Life Insurance: $10,000.

MISSOURI
- Realty: $1,500 in country land, $3,000 in city property (population over 40,000), and $1,500 in city property (population less 40,000).
- Personal Property, or Additional Realty: $300.
- Wages: 90 per cent to heads of families.

MONTANA
- Unmarried Person: Wearing apparel only.
- Realty: $2,500.
- Personal Property: $200.
- Wages for 40 days.

NEBRASKA
- Homestead $2,000 or Personal Property: $500.
- Wages: 90 per cent to heads of families.

NEVADA
- Homestead: $5,000.
- Necessary household furniture.
- Wages: Not to exceed $50.

NEW HAMPSHIRE
- Homestead: $500.
- Furniture: $100.
- Tools, Implements, etc.: $100.
- Wages: $20 (except for necessities).

New Jersey

Homestead: $1,000.
Personal Property: $200.
Wages: Over $18 per week subject to garnishment of 10 per cent.

New Mexico

Homestead: $1,000.
Household Furniture.
Tools, Implements, etc.: $150.
Wages: No more than 20 per cent for last 30 days may be garnished unless in excess of $75.

New York

Homestead: $1,000.
Household Goods: $250.
Wages: 60 days.

North Carolina

Homestead: $1,000.
Personal Property: $500.
Wages for 60 days.

North Dakota

Homestead: $5,000.
Personal Property: $500.

Ohio

Homestead: $1,000; or,
Personal or Real Property: Not to exceed $500.
Household Furniture: $35.
3 months' earnings (if head of family).

Oklahoma

Homestead: $5,000.
Household Furniture.
Tools and Implements.
Wages for 90 days.

Oregon

Homestead: Owned and occupied by family not to exceed $3,000.
Household Goods: $300.
Wearing Apparel: $100.
Tools, Implements, etc.: $400.
Wages for preceding month, not to exceed $75.

PENNSYLVANIA

No Homestead.
Real or Personal Property: $300.
All wages.

RHODE ISLAND

No Homestead.
Tools, Implements, etc.: $200.
Household Furniture: $300.
Salary or wages to amount of $10.

SOUTH CAROLINA

Homestead: $1,000.
Personal Property: $500.
Wages for 60 days.

SOUTH DAKOTA

Homestead: $5,000.
Personal Property: $750 for married men and $350 for single men.
Wages for 60 days.

TENNESSEE

Homestead: $1,000.
90 per cent of income already earned by one earning $40 a month or less; and $36 when the amount exceeds $40.

TEXAS

Homestead: $5,000.
Household Furniture:
Implements and Tools:
Current wages.

UTAH

Homestead: $1,500.
Household Furniture: $300.
Implements, Tools, etc.: $300.
Wages: ½ earnings for 30 days.
Life Insurance: Premium not to exceed $500.
$500 for wife; $250 for each other member of family.

VERMONT

Homestead: $1,000.
Personal Property: $200.
Tools, Implements.
Wages for 2 months not to exceed $50 a month.

Virginia
Homestead: $2,000 (must be recorded).
Household Belongings.
Tools, Implements, or Stock in Trade.
Wages not to exceed $50 a month.

Washington
Homestead: Consisting of dwelling house in which claimant resides.
Furniture: $500.
Tools, Implements, or Stock in Trade:
Current Wages: $100 (not to exceed 4 weeks' pay).

West Virginia
Homestead: $1,000 (must be recorded).
Personal Property: $200 (if married).
Tools and Implements: $50.
Current Wages.

Wisconsin
Homestead: $5,000.
Household Furniture: $200.
Wages: Married man, 3 months (not to exceed $180).

Wyoming
Homestead: $2,500.
Household Belongings: $500.
Tools, Implements, etc.: $300.
Wages: ½ of wages for service rendered within 60 days of executions, not to exceed $100.

For ready reference purposes, complete digests of the state exemption laws are contained in the quarterly rating books of both Bradstreet and Dun.

Meaning of "Due Process of Law"

By "due process of law," in this connection, is meant that in order to obtain a valid personal judgment against a debtor he must be personally served with notice of the suit within the state. Or, to put it in another way, it means that you cannot obtain a valid personal judgment (directing a person to do something) which will be recognized by and enforced in other states, where notice of the suit is given to the debtor, outside

the state, by publication. A state statute may authorize the rendering of personal judgments where the debtor has been served with notice by publication, but other states are *not compelled* to recognize and enforce them, because such judgments are not deemed to have been obtained by due process of law.

The importance of this fact is brought out in a situation where a judgment has been obtained, say in the New York courts, against a non-resident debtor, who has been served with notice of the suit by publication; and you then wish to execute the judgment against property of the debtor within the state of New York. It cannot be done, because your judgment is invalid—there having been no personal service within the state—and you therefore cannot seize property of the debtor within the state to satisfy it.[1] Does this mean that a creditor is powerless to subject the property of a non-resident debtor to the satisfaction of his claim or account? No, it simply means that it must be accomplished in a different way.

Proper Way to Subject Property of a Non-Resident to a Creditor's Claim

The proper procedure to be followed when you are dealing with such a situation is:

1. Attach the property on the ground that the debtor is a non-resident of the state (always a good ground for attachment).
2. Get a judgment against the property thus attached.

Such a judgment is not a personal judgment against a person outside the state, and therefore outside the jurisdiction of the state courts, but a judgment against property within the state and therefore within the jurisdiction of the state courts.

In other words, if you have a claim against a non-resident who has property within the state which can be levied on and

[1] Pennoyer v. Nehf, 59 U. S., 714.

subjected to execution: (1) attach the property, (2) get a judgment against that particular property.

Enforcement in One State of Judgment Obtained in Another

It is not an uncommon view in the commercial world that once a legal judgment is obtained against a debtor in one state, it is enforcible against the person or property of the debtor in any and every other state, on somewhat the same theory or principle that a marriage valid in the state in which it is performed is recognized as valid in every other state. While the latter statement, from a strictly legal viewpoint is true, the former is not. By this is meant that it is entirely possible for a creditor to obtain a judgment against a debtor which is enforcible only within the state in which it was obtained, that is, a judgment which will be given no ex-territorial effect. Hence the importance to a credit man of knowing just when and under what circumstances and conditions a judgment can be obtained against a debtor which may be enforced against property of the debtor located in another state; and of knowing the manner in which and procedure whereby such judgments are executed and enforced in foreign states.

State Jurisdiction Confined to State

In the first place, the fact must be recognized that each state is a sovereign unto itself and has a sovereign's right to exercise control over all property and persons within the state. Therefore, after you have obtained a judgment in one state and attempt to enforce it against the person or property of the debtor in another state, you are immediately confronted with this question: "By what right are you attempting to seize or attach property in this state," say New Jersey?

You then state your position to be that of a holder of a judgment obtained in New York, we will assume. But the New York courts have nothing to do with and exercise no jurisdiction or control over persons or property located within

the state of New Jersey. The exercise of their sovereign rights and powers is limited and confined to the state of New York. In other words, strictly speaking, the judgments of state courts are effective and binding only within the jurisdiction of the state in which they are obtained.

Effect of Constitutional "Full Faith and Credit Clause"

We turn now to article 4, section 1, of the United States Constitution, which is known as the "full faith and credit clause" of the Constitution, and which provides that:

> Full faith and credit shall be given in each of these states to the records, acts, and judicial proceedings in every other state.

By that is meant that once you have obtained a *valid* judgment in one state by due process of law, the courts of other states are compelled to take judicial notice of that fact in this way:

In order to enforce a judgment in one state, say New Jersey, it must be a New Jersey judgment. But once you have obtained a valid judgment in another state, all you have to do in order to obtain a judgment to the same effect in New Jersey is to prove to the satisfaction of the New Jersey court that your judgment in the other state was obtained by due process of law, and on the strength of that fact they will grant you a New Jersey judgment, thereby enabling you to enforce the judgment obtained in the other state, within the state of New Jersey. This is what is meant by the "transfer of a judgment from one state to another," discussed below.

The principal difference between the two judgments thus obtained lies in the manner in which they are obtained. To get your first judgment you have to prove your original cause of action, whereas to obtain your second, all you have to do is to prove that your first judgment was obtained by due process of law.

Procedure Incidental to the Transfer and Enforcement of Judgments from One State to Another

The procedure incidental to the transfer and enforcement of judgments can perhaps best be explained by means of a concrete illustration. Let us take the case of X suing Y for goods sold and delivered, in the Supreme Court of New York County, for the sum of $3,500, and let us assume that X recovers a judgment against Y for that amount by default, owing to Y's failure to defend the suit. Let us also assume that an execution has been levied against the property of Y in New York, but the sheriff finds that Y has moved to Newark, New Jersey, and returns the writ of X unsatisfied. What remedy has X now against Y?

X can go to the Supreme Court of New York County and get an exemplified copy of the New York judgment roll, which consists of a copy of the judgment roll signed by the judge of the court and two clerks of the court, and contains a copy of the summons, the pleadings, admissions, the final judgment, any interlocutory judgment or decrees, and a copy of any paper or order on file which in any way involves the merits or necessarily affects the judgment. If judgment is entered by default, the written proof required to be filed by the plaintiff and the result must be contained in the judgment roll, together with the damages assessed. The judgment roll does not, and should not, contain any evidence of the case.

X then brings his action against Y in the Supreme Court of New Jersey, in the city of Newark, and Y is accordingly served with a summons to appear in this action. X presents his exemplified copy of the New York Supreme Court judgment roll, and alleges that the Supreme Court of New York had jurisdiction over the subject matter of the action and likewise the amount involved. He further alleges that no part of the sum has been paid, that the execution levied under the judgment was returned unsatisfied, and then rests his case.

On the strength of these allegations the New Jersey

Supreme Court will give X a judgment for $3,500 plus costs against Y. The sheriff of Newark will then levy on Y's property and collect the $3,500 judgment plus the costs of the New York judgment. In other words, X gets double costs against Y, as the New York costs are added to, and included in, the judgment roll when X presents it to the New Jersey court.

CHAPTER XXV

GENERAL RIGHTS AND REMEDIES

1. Legal Rights and Remedies of the Seller

Unpaid Seller's Lien

An unpaid seller of merchandise is protected by law to the extent that under certain circumstances and conditions he may exercise special rights against the goods sold notwithstanding the fact that title to the goods has passed to the buyer. A seller is still unpaid if he has been given a bad check or note in return for the goods. The first of these rights that we will consider is the unpaid seller's lien.

A lien is the right of one party to retain in his possession goods, the title to which is in another party, until the demands of the party in possession have been satisfied. In other words, in the case of the unpaid seller's lien, the term implies that the purchaser continues to be the owner of the goods, but that the seller, who is described as the "holder" of the lien, has acquired a claim upon the goods—not a claim of ownership, but a claim of right to hold the goods as security for the performance of the obligation of the purchaser to pay for them in accordance with his promise.

As for the circumstances under which this right or remedy may be exercised, there are two possibilities to be considered:

1. When No Credit Is Extended. Where merchandise is sold without any agreement as to the extension of credit to the buyer, title may pass, but the seller may retain possession of the goods, or exercise a seller's lien, until paid for. In other words, where you have a bargain and sale at an agreed price, the modern presumption is that title to the goods passes

immediately, but the seller retains a lien on the goods until paid for.

2. When Credit Is Extended. Even where the goods are sold on credit, if the buyer becomes insolvent before delivery the seller thereupon becomes vested with the right to exercise an unpaid seller's lien and to refuse to deliver the goods until paid for.

The theory or principle upon which this right is based is that, while the seller, in extending credit to the buyer, waived his lien or right to hold the goods until paid for, he did so on the implied condition that the buyer's credit standing and financial responsibility would remain unimpaired. It is the breach of this implied condition which gives rise to the right or lien.

When the Right May be Exercised

The lien of the unpaid seller for the purchase price of the merchandise exists only: (1) when the seller has sold for cash; (2) when, having sold on credit, the time for the credit has expired before delivery of the goods has been made; or (3) when, having been sold on credit, the buyer becomes insolvent before delivery.

The Uniform Sales Act which has been enacted in 22 states, sets forth the principles governing the unpaid seller's lien in sections 54-56 as follows:

> (1) Subject to the provisions of this act, the unpaid seller of goods who is in possession of them is entitled to retain possession of them until payment or tender of the price in the following cases:
>
> (a) Where the goods have been sold without any stipulation as to credit.
>
> (b) Where the goods have been sold on credit, but the term of credit has expired.
>
> (c) Where the buyer becomes insolvent.
>
> (2) The seller may exercise his right of lien notwithstanding that he is in possession of the goods as agent or bailee for the buyer.

Where the unpaid seller has made part delivery of the goods, he may exercise his right of lien on the remainder, unless the part delivery has been made under such circumstances as to show an intent to waive the lien or right of retention.

When Lien Is Lost

The lien of the unpaid seller is lost as soon as he parts with possession of the goods, or as soon as the purchaser tenders the purchase price and demands delivery. The Uniform Sales Act provides in section 56:

> (1) The unpaid seller of goods loses his lien thereon:
> (a) When he delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the property in the goods, or the right to the possession thereof.
> (b) When the buyer, or his agent, lawfully obtains possession of the goods.
> (c) By waiver thereof.
>
> (2) The unpaid seller of goods, having a lien thereon, does not lose his lien by reason only that he has obtained judgment or a decree for the price of the goods. The obtaining of a judgment or decree for the purchase price of the goods by the seller does not operate to extinguish the lien. In other words, the lien is not merged in the judgment. Otherwise, it might amount to compelling the seller to surrender his goods in return for a worthless judgment.

When Lien Is Revived

If the buyer for his convenience, or any other motive, has left the goods in the custody of the seller until the credit period has expired, or has become insolvent before the credit period has expired, the seller's lien is revived on the ground that the waiver was conditional on the buyer maintaining himself in good credit. In other words, if goods are sold on credit and nothing is agreed as to the delivery of the goods, the buyer is immediately entitled to possession, but his right of possession is not absolute and is liable to be defeated if he fails to take

delivery within the credit period, or if he becomes insolvent before he obtains possession.

Stoppage in Transit

In considering the unpaid seller's lien as one of the unpaid seller's legal rights, it was pointed out that such a lien exists and continues in effect only so long as the seller retains possession of the goods. It therefore follows that, as a general rule, when the seller has voluntarily parted with the actual possession of the merchandise he is no longer in a position where he can avail himself of this means of protection. An exception to this general rule, however, is found in the second of these creditor's rights and remedies, namely, the right of stoppage in transit, wherein the law goes still further in protecting the seller of merchandise and provides that even if the seller has actually despatched the goods to the buyer and insolvency occurs, he has a right by virtue of his original ownership to stop the goods in transit, because, whereas title to the goods has passed to the buyer on delivery to the carrier so as to subject him to the risk of loss, he has not an indefeasible right to the possession, and his insolvency without payment of the price defeats that right.

Extent to Which a Creditor Is Protected by the Bill of Lading

This is merely a statement of the general principle of stoppage in transit, and in order to understand the limitations placed upon its practical application it is first necessary to explain the different kinds of bills of lading that may be used in making shipment.

In the first place, a bill of lading is of a twofold nature in that it represents: (1) a receipt for the goods shipped, and (2) a contract to deliver as directed in the bill of lading. This contract to deliver may also be said to be of a twofold nature, in that the obligation of the carrier may be to deliver the goods

to A, the buyer, or to A "or order." In the former case, where the carrier is directed to deliver the goods to a particular consignee and none other, the bill of lading is said to be a "straight" or "non-negotiable" bill of lading; in the latter case, where the carrier is directed to deliver the goods to a designated consignee "or order," the bill of lading is said to be "negotiable."

The important points to be noted in connection with the distinction between the two are:

1. The carrier does not, as a rule, demand the surrender of a straight or non-negotiable bill of lading before making delivery to the consignee. The consignee in such instances merely has to identify himself sufficiently as the designated party in the bill of lading.
2. The carrier does demand the surrender of an order bill before he will surrender the goods. The reason for this is that, being negotiable, the bill of lading (representing the right to receive the goods) may have been transferred to some third party by the original consignee.

The following four cases will suffice to illustrate the extent to which the creditor may go in the exercise of his right of stoppage in transit:

Under a Straight or Non-Negotiable Bill of Lading

1. Suppose that after the goods are shipped to the buyer under a straight bill of lading, you learn of the buyer's insolvency. Even though title to the goods has passed to the buyer on delivery to the carrier, the seller may stop delivery of the goods at any time prior to the actual delivery of them to the buyer, and have them returned or held subject to other disposition.

2. Suppose that the goods are shipped under a straight bill of lading, which is sent to the buyer, who indorses and transfers it to a bona fide purchaser for value before insolvency or

after insolvency. In neither case is the seller's right of stoppage cut off as against the transferee, because the transfer of a straight or non-negotiable bill of lading amounts to nothing more than an assignment of the buyer's rights under the bill of lading. Consequently, inasmuch as the shipper could stop the goods from being delivered to the original consignee, he can also exercise the same right against the consignee's transferee of the bill of lading.

Under an Order or Negotiable Bill of Lading

3. Suppose that after the goods are shipped under an order or negotiable bill of lading, you learn of the buyer's insolvency, and that the bill of lading still remains in the possession of the consignee (has not been negotiated to a third party). Just as in case (1), the seller may stop delivery of the goods at any time prior to the actual delivery of them to the buyer.

4. Again, suppose that the goods are shipped under an order bill which is sent to the buyer who negotiates it to a bona fide purchaser for value before becoming insolvent or after becoming insolvent. In either case the transfer operates to cut off the seller's right of stoppage against the transferee, section 62 of the Uniform Sales Act providing:

> If, however, a negotiable document of title has been issued for goods, no seller's lien or right of stoppage in transit shall defeat the right of any purchaser for value in good faith to whom such document has been negotiated, whether such negotiation be prior or subsequent to the notification to the carrier, or other bailee who issued such document, of the seller's claim to a lien or right of stoppage in transitu.

Although it seems unjust and inequitable to permit a debtor to transfer title to your goods after he has become unable to pay for them, the theory or principle upon which the ruling giving him such right is based is that it is considered more expedient from a commercial point of view to limit the right of

stoppage in transit of a seller who has entrusted the buyer with an apparently good title to the goods, than to deprive the innocent purchaser for value of his acquired right to the goods, particularly in view of the fact that the established policy of the courts has always been to encourage the transfer of such negotiable documents of title ever since they first received legal recognition and protection in the law courts.

A possible fifth case might well be added, wherein the consignee under an order bill sells the goods to a third party without transfer or negotiation of the bill of lading. Such a sale would in no way affect or cut off the seller's right of stoppage, because title to the goods, as represented by the bill of lading, was not transferred.

Grounds for Exercise of the Right

The right of stoppage in transit is a legal right which rests solely upon the insolvency of the buyer, and is based on the plain reason of justice and equity that one man's goods shall not be applied to the payment of another man's debts. Actual or technical insolvency of the buyer is not an absolute requisite. It will suffice if the purchaser by the manner of conducting his business and meeting his obligations, manifests the usual evidences of insolvency. Thus, the right exists where the purchaser has not been able to meet his bills at maturity, or has permitted his notes to be protested because of his inability to pay them in the regular course of business.

Consequences of Stoppage in Transit

The effect of the exercise of this seller's right is simply to restore the goods to the possession of the seller so as to enable him to exercise his other rights as an unpaid seller. But the mere fact that the seller has exercised this right does not in and of itself have the effect of rescinding the sale.

The buyer whose goods have been stopped in transit, or those who stand in his place, may still claim and exercise the

right of possession if they will pay or tender the purchase price of the goods to the seller.

If the seller stops the goods in transit when in fact no reasonable grounds for inferring the insolvency of the buyer exist, he may be compelled to deliver up the goods, and, in addition, made to answer for any damage or loss caused the buyer by the delay. Furthermore, if the seller, having stopped the goods in transit, resells them when he ought not, the buyer may bring a special action against him for the damage sustained by such wrongful sale.

When Does the Transit Begin and End?

The transit of goods begins the moment the seller or his agent delivers the goods to the carrier. It is ended whenever the buyer or his agent gains possession of the goods, or whenever the goods arrive at their destination and the carrier agrees to hold them as agent for the buyer.

Section 58 of the Uniform Sales Act sets forth the circumstances and conditions under which the goods are to be construed as being in transit:

> (1) Goods are in transit within the meaning of section 57,
>
> (a) From the time when they are delivered to a carrier by land or water, or other bailee for the purpose of transmission to the buyer, until the buyer, or his agent, takes delivery of them from such carrier or other bailee;
>
> (b) If the goods are rejected by the buyer, and the carrier or other bailee continues in possession of them, even if the seller has refused to receive them back.
>
> (2) Goods are no longer in transit within the meaning of section 57,
>
> (a) If the buyer, or his agent, obtains delivery of the goods before their arrival at the appointed destination.
>
> (b) If, after the arrival of the goods at the appointed destination, the carrier or other bailee

acknowledges to the buyer or his agent that he holds the goods on his behalf and continues in possession of them as bailee for the buyer or his agent; and it is immaterial that a further destination for the goods may have been indicated by the buyer.

(c) If the carrier or other bailee wrongfully refuses to deliver the goods to the buyer, or his agent.

(3) If goods are delivered to a ship chartered by the buyer, it is a question depending on the circumstances of the particular case, whether they are in possession of the master as a carrier or as agent of the buyer.

(4) If part delivery of the goods has been made to the buyer, or his agent, the remainder of the goods may be stopped in transit, unless such part delivery has been made under such circumstances as to show an agreement with the buyer to give up possession of the whole of the goods.

Manner in Which the Right Is Exercised

No particular form or mode of stoppage has been held necessary in any case. When the seller wishes to exercise his right of stoppage in transit, he must immediately notify the carrier of the fact, and from the time the carrier receives the notice he is under obligation not to deliver the goods to the buyer. If he does deliver the goods to the buyer after receiving such notice from the seller, he acts at his peril, section 59 of the Uniform Sales Act providing:

1. The unpaid seller may exercise his right of stoppage in transit either by obtaining actual possession of the goods, or by giving notice of his claim to the carrier, or other bailee in whose possession the goods are. Such notice may be given either to the person in actual possession of the goods, or to his principal. In the latter case, the notice, to be effectual, must be given at such time and under such circumstances that the principal by the exercise of reasonable diligence may prevent a delivery to the buyer.

2. When notice of stoppage in transit is given by the seller to the carrier, or other bailee in possession of the goods, he must

> redeliver the goods to, or according to the directions of, the seller. The expenses of such delivery must be borne by the seller. If, however, a negotiable document of title representing the goods has been issued by the carrier or other bailee, he shall not be obliged to deliver or justified in delivering the goods to the seller unless such document is first surrendered for cancellation.

If the carrier wrongfully surrenders the goods to the buyer after being properly notified by the seller to stop the goods, he becomes liable to the seller in an action either: (1) in tort for conversion of the goods; or (2) for breach of contract. Reservation of this legal right of stoppage in transit in the seller constitutes an implied (when not an expressed) condition of the contract to deliver, and it is the breach of this implied condition which gives rise to an action for breach of contract.

When in doubt as to the proper party to whom to deliver the goods, the carrier as a rule returns the goods to the seller, who is required to execute an indemnity bond to protect the carrier against any claim that may be set up against him by a third party.

Right of Resale

Assuming the seller has possession of the goods as a result of having exercised his unpaid seller's lien, or has recovered them through the exercise of his right of stoppage in transit, what may he do with them? Title still remains in the buyer, but if he does not exercise his right to tender the purchase price and claim the goods within a reasonable time, the seller may resell the goods to some third person, who in such a case would get a valid title thereto. In so doing he really acts as the agent of the buyer in whom the title rests, and makes the resale merely to realize upon his lien for the purchase price. And yet it can hardly be said that he resells the goods for the buyer's account, because if that were so and the goods were sold at a profit the original buyer would be entitled to that profit.

Time and Manner in Which Right May be Exercised

Section 60 of the Uniform Sales Act prescribes the time and manner of the resale, by providing:

> 1. Where the goods are of a perishable nature, or where the seller expressly reserves the right of resale in case the buyer should make default, or where the buyer has been in default in the payment of the price an unreasonable time, an unpaid seller having a right of lien, or having stopped the goods in transit, may resell the goods. He shall not thereafter be liable to the original buyer upon the contract to sell or the sale or for any profit made by such resale, but may recover from the buyer damages for any loss occasioned by the breach of the contract or the sale.
>
> 2. Where a resale is made, as authorized in this section, the buyer acquires a good title as against the original buyer.
>
> 3. It is not essential to the validity of a resale that notice of an intention to resell the goods be given by the seller to the original buyer. But where the right to resell is not based on the perishable nature of the goods or upon an express provision of the contract or the sale, the giving or failure to give such notice shall be relevant in any issue involving the question whether the buyer had been in default an unreasonable time before the resale was made.
>
> 4. It is not essential to the validity of a resale that notice of the time and place of such resale should be given by the seller to the original buyer.
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> 5. The seller is bound to exercise reasonable care and judgment in making a resale, and subject to this requirement may make a resale either by public or private sale.

Right of Rescission—When It May be Exercised

The right of stoppage in transit, although it may seem equivalent in effect to a right of rescission in the limited class of cases where it is applicable, does no more than continue the seller's lien after the property has passed from his possession. However, if the seller has not parted with the goods or has regained his lien by the exercise of his right of stoppage in transit, he is allowed to rescind the sale on default of the

buyer and keep the goods as his own, the rule being that "a seller still in possession of the goods may, on default or repudiation of the buyer, revest himself with title when:

1. The right to do so is reserved in the contract to the seller.
2. Buyer is in default an unreasonable length of time.
3. Buyer has repudiated the sale or is obviously unable to perform.

In case of a later resale, the seller need not account to the buyer for any profits made by virtue of the rescission, and if the value of the goods at the time the sale is rescinded is less than the damage the seller has suffered as the result of the default of the buyer, he may also sue for the difference.

As a condition precedent to the exercise of this right, notice of the rescission and retransfer of title should be given to the buyer although it has been held not to be necessary.

Time and Manner in Which the Right May be Exercised

Section 61 of the Uniform Sales Act also provides the time and manner in which the seller may rescind the original sale:

> 1. An unpaid seller having a right of lien, or having stopped the goods in transitu, may rescind the transfer of title and resume the property in the goods, where he expressly reserved the right to do so in case the buyer should make default, or where the buyer has been in default in the payment of the price an unreasonable time. The seller shall not thereafter be liable to the buyer upon the contract to sell or the sale, but may recover from the buyer damages for any loss occasioned by the breach of the contract or the sale
>
> 2. The transfer of title shall not be held to have been rescinded by an unpaid seller until he has manifested to the buyer by notice or some other overt act an intention to rescind. It is not necessary that such overt act should be communicated to the buyer but the giving or failure to give notice to the buyer of the intention to rescind shall be relevant in any issue involving the question whether the buyer had been in default an unreasonable time before the right of rescission was asserted.

In cases where the buyer has committed a fraud in obtaining the goods, the seller may recover the goods, even though they have been delivered to the buyer, for the perpetration of fraud makes transfers of goods voidable.

Action for Breach of Contract

The seller may maintain an action against the buyer for the purchase price of the goods in the following situations:

1. Where title to the goods has passed and the buyer wrongfully refuses to pay for them according to the terms of the contract or sale.
2. Where the price is payable on a specific day irrespective of delivery or transfer of title and the buyer wrongfully refuses to pay.

An action may also be brought for damages for non-acceptance:

1. Where the buyer wrongfully refuses to accept and pay for the goods.
2. Where the buyer repudiates the contract or sale and notifies the seller to proceed no further in carrying out the agreement.

Measure of Damages

In general, the rule is that where a buyer repudiates a contract or refuses to accept and receive the goods, the measure of damages is the difference between the contract price and the market value of the goods at the time and place of delivery. If the goods have no market value, the seller may recover for the loss shown to have resulted directly and naturally from the breach. If the buyer repudiates the contract or sale before it has been fully performed by the seller, the buyer may thus limit his liability to the expense incurred by the seller prior to the repudiation, plus the profit to be derived from the transaction.

2. Legal Rights and Remedies of the Buyer

Grounds for Right of Action

Contracts to sell goods and sales agreements may be breached by the seller as well as by the buyer, and while a mercantile creditor is primarily interested in and concerned with the enforcement of his legal rights and remedies growing out of a breach by the buyer, nevertheless it is also well to know the extent to which a seller becomes legally liable for a breach of contract on his part. The buyer's right of action may arise from either the breach of a contract to sell, or a contract of sale, depending upon whether title to the goods passes from the seller to the purchaser at the time of the agreement.

Right of Action for Conversion

1. Nature of Right. If the transaction amounted to a sale of the goods and title has passed, then if the seller wrongfully refuses to deliver the goods the buyer may maintain an action for conversion of the goods belonging to the buyer as the result of the sales agreement. In such a case, however, the buyer does not recover the goods which constituted the subject matter of the transaction, but only damages.

2. Measure of Damages. The measure of damages recovered in such an action is the difference between the contract price and the market value of the goods at the time of the conversion:

Contract price of goods	$2,500
Value at time of conversion	3,500
Damages recovered	$1,000

Right of Action for Breach of Contract

1. Nature of Right. If, instead of a sale, the transaction constituted a contract to sell, and title to the goods has not passed, then, if the seller wrongfully refuses to deliver the

goods, the buyer may maintain an action for damages for breach of contract.

2. MEASURE OF DAMAGES. The measure of damages recovered in such an action is the loss directly resulting to the buyer from the breach.

Contract price of goods	$2,500
Potential profit from resale of goods	3,500
Damages recovered	$1,000

Right of Specific Performance

NATURE OF RIGHT. In neither of the above actions has the buyer a right to recover the goods in specie, but damages only, the theory being that given sufficient damages to compensate him for his loss resulting from the breach, the buyer may go out into the open market and repurchase substantially the same goods for which he had previously contracted.

In a proper case, however, the court may decree a specific performance of the contract by the seller. By a "proper case" is meant that when the nature of the goods constituting the subject matter of the agreement is such that they cannot be replaced, or if a satisfactory substitute therefor cannot be obtained in the open market, the buyer is entitled to the benefit of his bargain which under such circumstances can be obtained only by receiving the goods in specie. In other words, while the courts will not, as a rule, decree specific performance of an ordinary contract for the sale of goods, because the breach may be sufficiently remedied by damages, a sale of goods may be attended with such exceptional circumstances as to require its specific performance to render it effectual. For example, in the case of the Equitable Gas Company v. The Baltimore Coal Tar Company,[1] a contract was entered into whereby the defendant agreed to sell a certain quantity of coal tar to the plaintiff, and wherein it was con-

[1] 63 Md. 285.

tended that the product was not only indispensable to the business of the plaintiff, but also that a supply of it could not otherwise be obtained in the city of Baltimore. The court held that the contract was one of such a nature as to be specifically enforced.

Right of Action for Breach of Warranty

1. NATURE OF THE RIGHT. When the seller commits a breach of warranty (express or implied), the buyer may elect any one of several rights of action, but if he has claimed and been granted a remedy in any one of these ways he cannot later avail himself of any of the other remedies. Under his rights for breach of warranty, he may:

(a) Accept the goods and set up a counterclaim for damages when sued for the purchase price.
(b) Accept the goods, pay for them, and then maintain an action for damages resulting from the breach of warranty.
(c) If title to the goods has not passed, he may refuse to accept the goods and still maintain a suit for whatever damage he may have suffered as a result of the breach of warranty. This right is also permitted in some jurisdictions e.g., Massachusetts, when title has passed.
(d) Rescind the contract to sell, or sale, and refuse to receive the goods; or if the goods have already been received, return them, or offer to return them to the seller, and recover such part of the price as has been paid.

The buyer, however, may not exercise his right of rescission:

(a) If he knew of the breach of warranty at the time he accepted the goods;
(b) If he fails to give notice to the seller of his intention to rescind within a reasonable time after receiving the goods; or,

(c) Unless he is in a position to return the goods in substantially the same condition in which they were received. (If the deterioration or injury to the goods is due to the breach of warranty, such deterioration or injury does not prevent the buyer from rescinding the sale.)

The Uniform Sales Act also provides in section 69:

1. Where the buyer is entitled to rescind the sale and elects to do so, the buyer ceases to be liable for the price upon return ing, or offering to return, the goods; but if any part of the price has already been paid, the seller must repay such amount concurrently with the return of the goods or immediately after an offer to return the goods in exchange for the repayment of the price.

2. Where the buyer is entitled to rescind and elects to do so, if the seller refuses to accept an offer of the buyer to return the goods, the buyer is thereafter deemed to hold the goods as bailee for the seller, but subject to a lien to secure the repayment of any portion of the price which has been paid, and with the remedies for the enforcement of such lien as are allowed to an unpaid seller.

2. Measure of Damages. As a general rule or principle of law, the measure of damages for a breach of warranty is the loss directly and naturally resulting in the ordinary course of events from such breach. In the case of warranty as to the *quality* of the goods, such loss is measured by the difference between the value of the goods at the time of delivery to the buyer and the value they would have had if they had been as warranted.

CHAPTER XXVI

THE PROVISIONAL REMEDY OF ATTACHMENT

Attachment Defined

The importance of attachment as a special remedy which is available to creditors is perhaps most appreciated by those who have learned from experience that it is not only entirely possible but sometimes actually develops that a debtor who apparently possessed ample assets at the time the suit was brought is found to be execution-proof, and those assets untraceable after a judgment has been obtained. Hence the practical value and advantage of a writ of attachment as a precautionary measure against such a contingency.

Attachment is a legal proceeding whereby a lien on property of the debtor is secured for the benefit and protection of creditors. By "lien" we mean the legal right of a creditor to compel the property thus attached to answer for the obligation.

Although for some purposes the issuance of the writ and the seizure of the property thereunder constitute a separate legal proceeding, yet it can have no independent existence. The attachment is ancillary to, and dependent on, a principal proceeding, either in law or in equity, which has for its purpose a determination of the creditor's demand. It is, therefore, tantamount to an involuntary dispossession of the defendant prior to any adjudication of the rights of the plaintiff—an execution, so to speak, in advance of trial and judgment. In other words, attachment is a provisional remedy for the collection of an ordinary debt whereby a preliminary levy upon the property of the debtor may be made in order to preserve it to the creditor until his lien shall have been per-

fected by judgment on a debt, for which suit has been or is about to be brought. In the latter case, suit must be brought within a certain time after service of the writ of attachment (usually 30 days). Otherwise, jurisdiction over the property attached ceases.

Statutory Remedy

Attachment is a remedy entirely statutory, concerning which each state has its own statutes, but, in so far as the general principles of the law of attachment are concerned, the statutes of the different states are in many respects uniform. Being a harsh legal remedy, the attachment statutes are strictly construed and the writ will be issued only in those cases in which it is explicitly allowed by statute.

Kinds of Attachment

There are two kinds of attachments: (1) domestic attachment is a proceeding against the property or credits of a resident debtor; (2) foreign attachment is a proceeding against the property or credits of a non-resident debtor.

Suit Personal in Form but a Property Action in Substance

The writ of attachment is always preceded or accompanied by a summons, which is either served on the defendant personally or by publication. But the judgment in an attachment suit binds only the property attached, and not the debtor personally. It therefore follows that a plaintiff who fails to sustain the ground of his attachment cannot succeed in his action against the defendant personally.

However, it should not be inferred that the recovery of the plaintiff is restricted to the property attached, for while the property is held subject to such judgment as the plaintiff may recover, the judgment authorizes an execution also against other property of the debtor within the jurisdiction of the court, whether attached or not.

Property Attached but No Personal Service

If property is attached but no personal service of the summons is obtained on the defendant, or he does not appear, he is notified by publication. This brings him before the court only, however, for the purpose of dealing with the property attached. In other words, where the defendant is a nonresident, and is notified only by publication, he is before the court for all purposes except the rendition of a personal judgment, so that the judgment under such circumstances binds only the property attached.

The procedure in obtaining jurisdiction over absent defendants is governed by the statutes of the different states. The publication is generally intended as a substitute for personal service, and after proof of publication is made, both parties, so far as relates to appearance and pleading in court, stand in the same position as they would have occupied on the return of a summons personally served.

If the plaintiff recovers judgment against the defendant without his appearance, such judgment will have no effect in another state as a personal judgment against the debtor (see pages 293–296). But if the defendant appears and defends himself in person or by attorney, the judgment will have the same force and effect everywhere as a judgment recovered in an ordinary suit. Furthermore, the plaintiff cannot take judgment for a greater amount than that for which the attachment was issued, nor for any other cause than that stated in the attachment.

If no property is found to attach and there is no personal service on the defendant, or no appearance by him in the state, there is nothing to give the court jurisdiction, and a judgment against the defendant would under such circumstances be void.

Debts or Accounts Not Due

In the absence of statutory provision, the debt, or account, must be due or the attachment cannot be sustained. In some

states, however, an attachment is allowed on a debt not due, but under such statutes the debt must be an actual subsisting debt, which in time will become due. In other words, the statute does not apply to debts resting on a mere contingency as to whether they will ever become due to the attaching creditor or not.

Who May Bring Attachment

In general, any creditor is authorized to sue out an attachment. Where the remedy is given to a creditor, a creditor is one who has a right to require of another the fulfilment of a contract or obligation. Non-residents as well as residents may avail themselves of the writ of attachment, even where both parties are non-residents. A corporation, either foreign or domestic, as well as the individual person, may exercise the creditor's right of attachment.

Grounds for Attachment

Ordinarily the mere inability of a debtor to pay his debts will not justify attaching his property. Attachment is based on the assumed indebtedness of property, and it authorizes procedure against it only where the personal debtor cannot be effectively reached by ordinary process. Attachment, being a purely statutory remedy, is available only where one or more of the grounds enumerated in the statute exist. The principal grounds for resorting to this extraordinary remedy are substantially the same in all states, a few exceptional grounds existing in only a few states. These principal grounds are as follows:

1. That the debtor is a non-resident of the state (not county) where the writ of attachment is sought against the debtor's property located within the state.
2. That the debtor has departed from the state with intent to defraud creditors or to avoid service of legal process.

3. That the debtor with like intent keeps himself concealed within the state.
4. That the debtor has removed property or is about to dispose of property for the purpose of defrauding his creditors.
5. That the debtor has secured property from the creditor by fraudulent representations, such as the making of a false statement in writing regarding his financial condition.[1]

Absent Debtors

Absence in the attachment law does not mean a mere temporary absence with intention to return. But an absence, even with an intention to return, is sufficient if it was taken to avoid proceedings by the creditor or naturally has that effect. One who removes to another state for purposes requiring his remaining there an indefinite time must be deemed a non-resident of the state he leaves for purposes of subjecting his property within the state to attachment, although he may intend to return in the remote future.

Absconding Debtors

An absconding debtor is one who hides, conceals, or absents himself from his usual place of abode with intent to avoid legal process. He need not go beyond the limits of the state. For example, a person who shuts himself up from his creditors has been held to be an absconding debtor. But one who leaves his abode without any fraudulent design, intending to return, is not an absconding debtor. An intention to abscond is not, in and of itself, sufficient; there must be an actual absconding, such as prevents service of process on the debtor. Whether a debtor has withdrawn himself from his creditors with intent to elude process to evade their demands is a question of fact to be submitted to the jury.

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[1] For creditor's right of attachment for violation of Bulk Sales Law, see Chapter XXIX.

Debtors Concealing Themselves

By this phrase is meant concealment by the debtor to avoid service of process with a view to defraud creditors, or for the purpose of gaining time in which to dispose of his property, lawfully or otherwise, before his creditors can gain access to him. It is the designedly placing of himself where his creditors cannot reach him with process, which constitutes the necessary concealment.

For example, if a person going away tells his neighbors and friends where he is going, the mere fact that he does not so inform his creditor does not amount to concealment. But if, in leaving, he request false information to be given of his movements, this is concealment. In other words, the concealment, to justify an attachment, must be to avoid or delay claims of creditors, and the debtor must also actually conceal himself to such an extent that he cannot be served with process.

Non-Resident Debtors

In all the states the fact that the debtor is a non-resident of the state is a good ground for an attachment against his property. Non-residence in the county in which the action is brought is not usually a ground of attachment. A person once acquiring a residence in a place does not lose it by going out of the state unless such removal is also accompanied by the intention to make such new place his home. A change of abode with the intention of not returning, however, makes one immediately a non-resident of the place from whence he parted. That a person has a place of business in the state and remains there during business hours, does not make him a resident if he lives outside the state. If he is a non-resident, the fact that he is at the time of the attachment temporarily in the state does not affect the validity of the attachment.

Once attachment proceedings have been instituted, an attachment against a non-resident will not be set aside on the ground that the defendant has since become a resident.

Removing Property from State

Where a statute authorizes attachment "where the debtor is about to remove his property from the state," it must appear that the property is of such a character that its removal out of the state is beyond its ordinary and customary use. Thus, the shipping of goods by the debtor to a creditor in another state in payment of a bona fide debt, or in the usual course of business, and without fraudulent intent is not a removal within the meaning of the statute. Furthermore, the mere fact that the defendant is removing part of his property is no ground for attachment if he has left, or intends to leave, sufficient other property to satisfy the debt. Nor does the taking of property out of the state for a mere temporary purpose, intending to bring it back, constitute a removal within the meaning of the statute.

However, to sustain the issue of the defendant being about to remove his property, it is not necessary to show that he is doing so with fraudulent intent, unless the statute so specifically provides. If the purpose to remove exists and the object is to evade or delay creditors, the writ may issue.

Concealing or Disposing of Property

"Disposing" of the property means any kind of alienation of it, whether by sale, gift, pledge, assignment, or other transfer. But a dealer's daily selling of his goods in the regular course of business is not within the statute, nor a mere threat of a debtor to make a preferential assignment.

It is not necessary to show that the defendant was about to dispose of all his property; the attachment will be sustained if it be shown that he was about to dispose of any part of it for the purpose of defrauding his creditors. An intent to defraud his creditors is essential, but fraud may, and will, be presumed where the defendant while in debt is about to put his property out of his hands, without consideration. It is not essential, in order to obtain an attachment, on the ground that

the debtor has fraudulently transferred or disposed of property, that the debtor be insolvent, although where he is not, it must be shown that a material portion of his property has passed.

It is not ordinarily considered a fraudulent transfer justifying attachment for a creditor to prefer one creditor over others, whether this is done by way of absolute conveyance of property in liquidation of the debt, by confessing a judgment in the creditor's favor, by way of mortgage to secure payment, or by way of actual payment of the debt. Under some statutes, however, a mere preference of one creditor over another is ground for attachment.

Property Subject to Attachment—Personal Property

As the sole object and aim of an attachment is to acquire and hold a lien upon property until it can be finally taken on execution, it follows that only such property should be attached as can be lawfully made subject to execution. In other words, the anticipatory levy by attachment should be governed by the rules applicable to the final levy under execution. In one respect, however, an attachment goes still further than an execution; it extends beyond the tangible property to which the latter is confined and seizes the accounts due to and property held for the debtor. But in respect to tangible property, real and personal, in the possession of the debtor, the rule is general that an attachment will affect such property, and such only, as may be levied upon and sold under execution. The test, therefore, as to whether certain personal property may be levied upon and sold under execution is—could the debtor legally transfer title to such property?

Choses in Action

Choses in action were not susceptible to levy at common law, due to the fact that, with the exception of negotiable instruments, they were not transferable so as to give the

assignee a right to sue thereon in his own name. This principle, however, has been so modified by statute in many of the states as to include choses in action within the meaning of the term "personal property."

Levy upon Interest in Shares or Bonds

The rights or shares which the defendant has in the stock of an association or corporation, or in a bond, negotiable or otherwise, together with the profits and interest therein, may be levied upon; and the sheriff's certificate of the sale thereof entitles the purchaser to the same rights and privileges with respect thereto which the defendant had when they were so attached.[2]

Equitable Interests

The common law rule was that nothing but legal titles could be made the subject of a levy. Consequently, the sheriff being required to make a manual seizure of the property, no levy could be made unless both the legal and equitable title were in the debtor. This rule still applies in the absence of special statutory provisions recognizing the right of levy upon equitable interests only. The rule is founded upon the theory that an attachment or execution, being based upon an action at law, should be restricted to legal interests. But where an equitable interest in personal property is combined with the possession and the right to hold it for a certain time, the interest is a leviable one, even in states holding the strict common law rule.

Property Covered by a Chattel Mortgage

It is this last-noted distinction that makes the equitable interest of a mortgagor of chattels chargeable by levy so long as he retains an absolute right of possession. But the interest of a mortgagor of chattels, being a purely equitable right to

[2] For example, see Section 915, Civil Practice Act of New York.

redeem, is not attachable unless the mortgage expressly gives him the right of possession.[3]

As regards the interest of the mortgagee, he has a leviable interest just as soon as the mortgagor has lost such interest. It cannot be owned by both at the same time; neither is there any period when it is not owned by either of them. Hence the rule being fixed that the right of levy shifts with the leviable ownership, inasmuch as the main object in a levy is to secure the immediate right of possession.

Property Pledged as Collateral Security

This rule as to the necessity of an absolute right of possession to constitute a leviable interest, operates to shield from attachment goods pledged for the security of a debt. Whereas the legal title in such cases is in the pledgor, he labors under the same disadvantage as a mortgagee who by virtue of the mortgage acquires the legal title, but is without the right of possession until the mortgagor is in default.

In several of the states this disability has been overcome by special legislation authorizing an attachment of such property, incapable of manual delivery, in the hands of the debtor. This extends the right to the interest of the mortgagor, pledgor, or consignor of goods, and constitutes an exception where a levy can be made upon the interest of a person in certain property but not upon the property itself.

Conditional Sales

The same principle applies to conditional sales where a condition precedent, namely, payment for the goods, prevents and delays the temporary passing of the legal title to the purchaser. In all such cases the purchaser does not take such a title to the property as to subject it to an attachment for his personal liabilities. The question then arises whether in such cases the goods may be attached in an action against the seller. On this

[3] 35 N. Y. 274.

point the well-founded principle has been laid down that inasmuch as property cannot be so placed as to shield it from the creditors of both parties to the transaction, it is inconceivable that the seller in such cases does not retain a leviable interest until such is acquired by the purchaser.

This subject is now dealt with in most states by special statutes.

Goods Sold but Retained in Possession of Seller

It is a debatable question as to how far the purchaser of goods which have not been actually delivered is to be protected against attaching creditors of the seller. If the goods remain in the possession of the seller after the sale, the attachment is generally held good, because the purchaser has allowed the seller to appear to be the absolute owner and the attaching creditor has a right to regard him as such unless he has a notice to the contrary.

The division of opinion on the issue involved, however, is well illustrated by the following two cases:

Plaintiff, an indorser on a note made by a shoe company, bought from the company a lot of goods in return for a promise to assume the note. The company was allowed to keep possession of the goods. Later it became insolvent. Plaintiff was allowed to recover against the assignee.[4]

A silk company executed a bill of sale of goods to a bank as security for indebtedness, but retained possession of the goods. Creditors of the company subsequently attached the goods. Court held that the conveyance to the bank was conclusively presumed to be fraudulent since the debtor retained possession.[5]

Fixtures

Fixtures are chattels that have become affixed to the realty. They may be subdivided into "movable" and "immovable"

[4] 22 S. E. Rep. 492.
[5] 92 Fed. Rep. 274.

fixtures. The former are personalty; the latter are realty.

The best general rule that can be adopted as to what property in the nature of fixtures can be attached as personalty, is that wherever the debtor has by law the right of sale and removal of the property, that right can be transferred to and exercised by a purchaser at a sheriff's sale and is therefore leviable under attachment and execution.

Immovable fixtures, being part of the realty, cannot be separately attached, but will pass under a levy upon the realty to which the fixtures are annexed. To become a part of the realty, there must be such an annexation as to render removal impossible without working a substantial injury to the freehold.

Real Estate—Prerequisites to Levy

Although personal property is primarily liable for the payment of debts, real estate may be levied upon in the absence of sufficient personalty to secure the creditor's claim. Under the statutes of some of the states a formal indorsement of the failure to levy upon sufficient personalty to secure the writ must be made thereon before attaching the realty. The mere fact that it is later shown that the debtor did possess sufficient personalty to secure the claim will not nullify the attachment on the real estate. It has even been held that the defendant, in order to raise objections on this ground, must, prior to the levy thereon, specifically designate personal property sufficient to cover the writ; and if the property is shown to be practically valueless, or so covered with mortgages as to be rendered unsalable, the sheriff may overlook it entirely and proceed at once against the debtor's landed interests.

Attachable Interests in Real Estate

The term "real estate" as used in the statutes affecting the attachment of realty includes all interests in lands, tenements and hereditaments, greater than that of a lease for years.

Interest of a Mortgagor

At common law a mortgage, which is nothing other than a deed or conveyance containing a defeasance clause, transferred title to the realty from the mortgagor to the mortgagee. Under the present-day doctrine, however, the mortgagor continues to be the owner of the estate until after the delivery of the deed under foreclosure proceedings. The mortgage, therefore, is a mere lien for the payment of a debt and as such is personal property. The mortgagee not having any estate in the property itself, it necessarily follows that the mortgagor's interest, the so-called "equity of redemption," is real estate and attachable as such.

Absolute Transfer as a Mortgage

A deed absolute on its face, but given as security for a debt, is in equity a mortgage; but the difference between such a deed and the ordinary mortgage, so far as creditors are concerned, is this: The deed transfers the legal title to the grantee, whereas the mortgage does not. In such a case the grantor's resulting interest has been considered a mere equitable interest to the extent that it cannot be levied upon as real estate.

Interest of a Mortgagee

Being a mere lien given as security for the payment of a debt and collateral to the principal obligation, the interest of a mortgagee is personalty and can only be attached as a chose in action. In other words, a levy cannot be made thereon as real estate.

Effect of a Levy upon Realty

Bearing in mind that the purpose of all attachment proceedings is to create and enforce a lien, the sole effect of the levy of an attachment upon real estate is to create a lien. It creates no interest in the property itself in favor of the attaching creditor. For this reason it creates no right to enter upon the

possession of the property, even for the purpose of improving or preserving its value; neither does it permit the attaching party to receive the rents or other profits therefrom. It is nothing more than a conditional claim to take effect in the future, provided the action shall proceed to judgment in favor of the creditor, or plaintiff.

Statutory Exemptions

Practically every state in the Union has a law exempting certain property from attachment. These exemptions have already been set forth (see pages 287–293).

Attachment Procedure

Having considered: (1) the nature of the creditor's right of attachment, and (2) the property of the debtor that is susceptible to the exercise of this right, we come now to (3) the enforcement of this right in the manner provided by law. Although the different states have separate statutes governing the right of attachment, the general principles applicable to its enforcement are also substantially alike.

When an attachment issues in a case pending in court, this auxiliary process must issue from and be returnable to the court in which such suit is pending.

Necessity and Nature of Affidavit

Most statutes require as a preliminary to the issuance of a writ of attachment that the plaintiff or creditor make an affidavit (Form 17) stating that one or more of the statutory grounds for the issue of a writ exist. Consequently, if there be no affidavit, or one with a total absence of the special grounds prescribed by law as essential to the issue of a writ, the writ so issued will be without legal jurisdiction and all subsequent proceedings, should there be any, would be void.

The affidavit may, however, contain the additional requisites of the complaint of the plaintiff, so as to dispense with

AFFIDAVIT FOR ATTACHMENT OF GOODS

State of ....*Ohio*....... }
County of ....*Hamilton*...... } ss   In the ..*Circuit*.. Court of Hamilton County.

......*James Ballard*.........
vs.   ..*November*.. Term, *192*—
.........*Paul Reece*.........

..*James Ballard*.. being duly sworn, deposes and says that ..*Paul Reece*.. is indebted to him the said ..*James Ballard*.., after allowing all just credits and set-offs, in the sum of ..*Ninety*.. dollars, for goods sold and delivered to said ..*Paul Reece*.. at his request, and that the said ..*James Ballard*.., (any one or more of the following grounds may be alleged)

(*1*) *is not a resident of this State;*......................................
(*2*) *conceals himself and stands in defiance of an officer so that process can not be served upon him;*..
(*3*) *has departed from this State with the intention of having his effects removed from this State;*..
(*4*) *is about to remove from this State with the intention of having his effects removed from this State;*...
(*5*) *is about to remove his property from this State to the injury of the said plaintiff;*...
(*6*) *has within two years preceding the filing of this affidavit fraudulently conveyed (or assigned) his effects so as to hinder or delay his creditors;*......,
(*7*) *has within two years prior to the filing of this affidavit fraudulently concealed (or disposed of) his property and effects so as to hinder or delay his creditors;*..
(*8*) *is about to conceal, assign, and otherwise dispose of his property and effects, so as to hinder and delay his creditors;*.............................
(*9*) *contracted the said debt fraudulently*..................................

AND affiant further says that the place of residence of said ..*Paul Reece*.. is ..*Cincinnati, Ohio*.., (or that upon diligent inquiry affiant has been unable to ascertain the place of residence of said ..*Paul Reece*..).

SUBSCRIBED AND SWORN TO before me this ..*10th*.. day of ..*November*.., 192—..

............*Andrew Hudson*.............
Clerk ..*Circuit*.. Court of ..*Hamilton*.. County

Form 17. Affidavit for Attachment of Goods

the necessity and inconvenience of preparing and filing any separate complaint as the basis of the creditor's suit.

Who May Make Affidavit

The affidavit may be made by the creditor, his agent, or attorney. In an affidavit made by an agent or attorney for the plaintiff, the affiant must describe himself as such, and state in the affidavit that he makes it on behalf of the plaintiff. Nor need he disclose his means of knowledge. But the affidavit must state the grounds for the attachment positively, though the amount set forth in the claim may be stated to be correct

"to the best of his knowledge and belief." The affidavit may be taken before any officer authorized to administer oaths.

Form of Affidavit

The affidavit should set forth: (1) the cause of action, or the indebtedness of the defendant, and (2) the existence of one or more of the special grounds for attachment. The following statements as to the claim and indebtedness have been held essential to the validity of the affidavit:

1. The amount of the indebtedness.
2. That the claim is just.
3. That no part of the debt has been paid.
4. The nature of the indebtedness, i.e., manner in which the debt accrued.
5. That he is not indebted to the defendant.
6. That the sum demanded is actually due.
7. The statutory ground for attachment.

The affidavit must follow and comply in all respects to the statutory requirements, and where a special form is prescribed by statute, it should be followed. But in any event the information set forth in the affidavit must be stated as matters of fact, and the affidavit is defective if, instead of stating necessary facts, it states merely inferences or conclusions of law.

Several Grounds Alleged in One Affidavit

The creditor, or plaintiff, may allege any number of grounds of attachment he pleases, and if any one of them is proved it will suffice to support the writ, though the others are disproved or not properly sustained. But the statement of two grounds of attachment in the alternative is bad, such as that the defendant "has assigned, or is about to assign his property," or that he "has transferred or secreted his property." Where, however, the disjunctive "or" is used to characterize and connect two distinct phases of the same act, and

not to connect two distinct facts of an altogether different nature, such as that the defendant "is indebted to said plaintiff *or* has in his hands effects of said plaintiff," the affidavit is good.

When to be Made and Filed

The affidavit may be made a reasonable time before the writ is issued; it need not be made on the very day, unless so required by statute. Likewise, it may be filed within a reasonable time after it is made.

How to Object to Faulty Affidavit

The most common method of objecting to an attachment on the ground that it is faulty or defective is by a motion to quash, or to vacate the attachment.

Waiver of Defects in Affidavit

By appearing and answering, the defendant waives defects in the preliminary proceedings. But appearing merely to move for the dismissal of the attachment does not waive the preliminary defects.

Defects May be Amended

In many states the statutes provide that a defective affidavit may be amended or a new one filed. And in such states a motion to amend may be granted, even after a motion has been made to vacate the attachment because of the defect.

The Attachment Bond

As a further preliminary, or condition precedent to the issuance of the writ of attachment, practically all the state statutes require the giving of a bond, or undertaking, by the plaintiff, with sufficient sureties, to the effect that if the defendant recovers judgment, or if the warrant is vacated, the plaintiff will pay all costs which may be awarded to the defendant, and

all damages which he may sustain by reason of the attachment, not exceeding the sum stipulated in the bond.

The bond usually provides for the payment of costs and damages to the defendant if the attachment has been "wrongfully issued or obtained." Under this phrase a mere failure to prosecute the attachment suit does not give rise to an action on the bond, nor the failure of the suit on technical grounds. Furthermore, if the plaintiff had good cause to believe the grounds for attachment true, the attachment is not wrongful. On the other hand, it has been held that an attachment sued out on a ground which did not exist, is wrongful, without regard to the belief of the person making the affidavit.

Burden of Proof

In such proceedings there is a presumption that the attachment was rightfully sued out, and in an action on the bond the burden of proof is on the defendant in the attachment suit to prove that it was wrongful. Where the defendant succeeds in his action on the bond, he is entitled to recover for the actual damages he has suffered as the natural result of the wrongful suing out of the writ. Such actual damages consist of:

1. Expense and losses incurred in making his defense to the attachment proceedings.
2. Loss occasioned by his being deprived of the use of his property during the pendency of the suit.
3. Effect of the attachment upon his credit standing.

Remote and speculative damages resulting from injury to his credit standing, business, or character cannot be recovered.

The Writ

The writ of attachment is nothing more than a formal order from the court to the sheriff to execute the same against the defendant's property.

The writ must follow the requirements of the statute and

it is analogous to a writ of execution, except that it emanates at the beginning instead of the termination of a suit. It must be under the seal of the court. It should also contain such material requisites as the nature of the action pending, the names of the respective parties to the suit, and the grounds upon which the court bases its authority to issue the writ.

The Levy

The sheriff to whom the writ or warrant is directed and delivered should immediately proceed to execute it in the manner therein prescribed, by attaching so much of the defendant's property, not exempt from levy, as will satisfy the plaintiff's demand, together with costs and expenses. Should the original levy prove insufficient he may levy from time to time and as often as it is necessary, until the amount for which it was issued has been secured. In fact, it is the duty of the officer on receiving a writ of attachment to execute it as soon as he reasonably can, and it has been held that if property is lost that otherwise might have been levied upon, due to any negligence on his part, he may be held liable for the damage resulting. Nor is it a sufficient excuse in such a case that the plaintiff failed to state that urgency was desired. The warrant itself usually specifies that fact, and such is the sheriff's duty independent of special instruction.

The test that has been laid down is this: Did the defendant have property concerning which the officer, by the exercise of reasonable diligence, could have learned, and upon which a seizure could have been made? No doubt a prudent creditor would, on delivering the writ to the officer, take pains to inform him where property subject to the writ could be found, and would co-operate with the officers in their attempt to execute the writ. But the plaintiff is not bound to pursue this course. He need only place the writ in the officer's hands for service. The officer must then make reasonable search and inquiry; and if such search and inquiry would have discovered prop-

erty, his omission cannot be excused by showing that the plaintiff neglected to point out anything upon which a levy could be made. Mere possession of personal property is prima facie evidence of ownership, and wherever it is shown that the sheriff had knowledge that the defendant was possessed of personal property, and he fails to levy upon it, the burden of proof falls upon him to show that the property was not subject to execution.

On the other hand, an officer is a trespasser who levies on property not subject to attachment. For example, an officer about to levy on personal property is bound by actual notice of a prior mortgage. Where the property is mixed with other property of the same kind belonging to a third party, so that it cannot be distinguished, the officer, in attaching the whole of it, is not liable for trespass, and it becomes the duty of the third party to claim and demand his portion from the officer. An officer may effect a forcible entry into a store or warehouse to attach property there, i.e., stock certificates, bonds, merchandise, etc., but he cannot force his way into a dwelling house against the will of the owner.

Manner of Making Levy

Personal Property. To constitute a good levy on personal property under an attachment, the officer must actually reduce it into his possession to such an extent that it cannot be withdrawn or taken by another without his knowing it. This rule applies likewise to promissory notes and bonds.

Where, however, the property is of an intangible nature and not susceptible of delivery (a chose in action), levy is made by serving upon the debtor a certified copy of the warrant of attachment together with a notice of the property thus attached. Levy can generally be made upon shares of stock in a foreign corporation, provided the certificates are within the state; if not, the levy cannot be made because it is necessary for the sheriff to obtain actual possession of the certificates.

In the case of shares in a domestic corporation, however, when a levy upon the certificates cannot be made by the sheriff, it may be effected by the sheriff delivering, or serving, a certified copy of the warrant, together with a notice of the shares attached, upon an officer of the corporation. If the corporation refuses to recognize the attachment, application should be made to the court for aid in effecting the levy.

Levy can be made on a note or chose in action only when and so long as the debtor or defendant has an interest in or title thereto. Consequently, a sheriff cannot levy on a note or chose in action which has been transferred to a bona fide purchaser for value but with the intent to defraud his creditors. It is still a chose in action, and when legal title is thus transferred to a third party it is no longer in the debtor and therefore cannot be attached as his property. In other words, a promissory note or chose in action which has been transferred in fraud of creditors cannot be attached by the sheriff.[6]

The rule with respect to other goods and chattels is different, however, in that goods and chattels which have been fraudulently assigned by a debtor to hinder, delay, and defraud his creditors are attachable in the hands of the fraudulent transferee in the suit of a creditor defrauded by the transfer.[7]

Therefore, a distinction must be made between a levy on choses in action and promissory notes which are fraudulently transferred, and a levy on goods and chattels other than choses in action and promissory notes, when fraudulently conveyed. In the case of the latter a valid levy may be made, provided, of course, that the transferee is not a bona fide purchaser for value.

As for heavy and bulky articles, or where the removal of the property attached would be attended with great waste and expense, the actual handling of the property may be dispensed with. In such instances the mode of procedure is to serve the

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[6] 96 N. Y. 180.
[7] 117 N. Y. 306.

proper person or officer of the corporation with a certified copy of the writ and notice that the property has been levied upon.

Real Property. To attach real estate, the officer need not go upon the land or even see it. It is sufficient for him to file a notice of attachment in the office of the county clerk, wherein the property lies, and to make a formal return on the writ that he has attached it. In fact he has no right to take actual possession of the land or to disturb the possession of the owner or occupant.

The Return

The officer having levied the attachment, it is his duty to make a return or formal report of it on or before a given time specified in the writ by the court and called the "return day." Otherwise the attachment will be dissolved. The formal return must set forth what action was taken, by whom, and how accomplished, together with the names of the parties in whose presence the writ was served. The officer must include in his return a specific description of the property attached, its kind, quantity, number, size, etc., as the case may be.

Lien Dates from Levy

The lien of an attachment does not date or take effect from the date of issue of the writ, but from the time of its actual execution, whereupon the attaching creditor acquires the right of the defendant in the property at the time the attachment took place. No interest subsequently acquired by the debtor in the property is affected. And, likewise, a previous assignment of the property is valid against a subsequent attachment.

The levy of an attachment is not a satisfaction of the plaintiff's demand; nor does the attachment transfer or change the ownership of the property, or take away his power of alienation subject to the creditor's lien thereon. Property seized under attachment practically amounts to nothing more than a legal

deposit in the hands of the sheriff pending termination of the action.

Lien Consummated by Judgment

The lien of the attachment is consummated, or made absolute, by judgment. Where lands of the defendant are attached and judgment is later rendered against him, the lien of the judgment will revert back and take effect as of the date of the attachment. If judgment be given for the defendant, the lien is thereby destroyed.

Successive Attachments on Same Property

Where there are several attachments against the same property, they are entitled to satisfaction in the order of their time of service, the second being entitled to the surplus left after satisfying the first, and so on. Where several attachments are simultaneously served on the same property, the proceeds derived from a sale of the property is prorated or distributed between all, each being entitled to an aliquot part.

Officer Must Hold Property

The duty of the officer after he has attached property is to retain possession of it. If he surrenders possession of it to anyone, he will be considered as having abandoned the attachment, and the creditor's lien will be lost. He may, however, at his discretion, release it upon the claim of a third party that he is the rightful owner, but the officer does so at his peril. He has no right to deliver it to the plaintiff. Neither has he any right to allow the property to remain in the possession of the defendant, or constitute the defendant his agent to keep the property for him. But possession of the goods attached need not be personal; he may place the property in the custody of a servant or agent, not the debtor, and the subsequent use by the debtor of such article does not affect any rights acquired by the attachment.

Dissolution or Vacation of the Attachment

In most states the attachment may be dissolved by the defendant giving a bond for the payment of such judgment as may be rendered against him. The acceptance of such bond releases the lien on the property. If the legal possession of the attached goods and chattels is lost, the attachment which is dependent upon such possession is *ipso facto* dissolved. But the mere removal of the property from the state by the person appointed to keep it in possession does not work a dissolution of the attachment.

Insolvency or Bankruptcy

A creditor's knowledge of the insolvency of his debtor is not sufficient to prevent him from obtaining a valid lien by attachment of the debtor's property, nor will a decree of insolvency against a debtor by the court of another state work a dissolution of an attachment of his property within the state. Furthermore, an attachment in a foreign state is not dissolved by a subsequent general assignment for the benefit of creditors in the debtor's state of residence.

If an attachment is levied more than four months prior to the filing of a petition in bankruptcy by or against the debtor, the lien of attachment is preserved by the federal Bankruptcy Act. Otherwise the attachment is dissolved by the Bankruptcy Law. But a dissolution of the attachment resulting from proceedings in bankruptcy will not defeat an action on the bond of indemnity, inasmuch as the bond, in such cases, operates a complete conversion and substitution for the property.

Death of the Defendant

In a personal action, the death of the defendant before final judgment abates the action and dissolves the attachment. But an attachment is not dissolved by the death of the debtor after judgment but before the property has been disposed of under execution. In some states, where the statute provides

that an attachment is not dissolved by death, it is necessary to revive the action against his personal representative in order to preserve the lien. This may usually be accomplished by a motion addressed to the court. When the attachment is dissolved it is the duty of the officer at once to redeliver the property to the defendant, but not necessarily to the place from whence he removed it.

CHAPTER XXVII

THE PROVISIONAL REMEDY OF GARNISHMENT

Illustration

The technical term of "garnishment" is derived from the French verb *garnir,* which means to give notice, or to warn.

The right of attachment, as was explained in the preceding chapter, is nothing more nor less than the right of a creditor to seize property in the possession of the debtor and have it applied in satisfaction of his claim or debt. But suppose you have this situation to deal with: You have a judgment for $500 against a debtor who is found to be execution-proof; but it later develops that in closing out his business, and in order to divest himself of all assets that could be attached by creditors, he loaned $1,000 to B. The debtor himself, it is assumed, has nothing of a tangible nature upon which you can levy an attachment, but he has a right to demand and receive the repayment of his loan to B, which right is worth $1,000. Consequently, if you could attach that right, have the money paid into court by B, and then applied in satisfaction of your judgment, your claim would be paid.

That, in brief, is the precise nature of this second provisional right of creditors—called the right of "garnishment," and as for its relative importance as a creditor's legal remedy, it has been said that for every payment that is enforced by attachment, twenty are collected by garnishment. In other words, where property has been transferred for the purpose of defrauding creditors, the creditors may, in many jurisdictions, hold the transferee liable as trustee to account for the property or its proceeds. It likewise applies to any case where a third

party has in his hands any funds or property belonging to the debtor. But, like the right of attachment, the right of garnishment is essentially a statutory remedy, and its scope and application is governed entirely by the statutes of each state.

Definition

The term "garnishment" is applied to a proceeding or process in the nature of attachment whereby the property, money, or credits of one person, generally called the "debtor," and in the possession of or owing by another, generally designated the "garnishee," are applied to the payment of the debt of the debtor by means of process issuing against the debtor and the garnishee.

The person instituting the proceedings is generally referred to as the "creditor" or "plaintiff"; the person indebted to the creditor is called the "debtor" or "defendant"; and the person in possession of the property sought and who is indebted to the debtor is called the "garnishee" (or "trustee"), or the one garnished, or warned (Form 18), by the creditor not to settle with the debtor but to answer to the suit of the creditor.

In some states the term "trustee process" and also "third party proceedings" are used to designate that which in most states is called "process of garnishment."

Nature of Garnishment

Garnishment, as a matter of formal procedure, is a suit whereby the plaintiff acquires a lien on the debt due from the garnishee to the defendant. It is not a new suit but always ancillary to the main action under which it is prosecuted. As a matter of substance, however, there is no real lien acquired, but rather a right to hold the garnishee personally liable for the debt, and to restrain the garnishee from paying the debt to the defendant.

A garnishee is regarded as an innocent person owing money, or having in his possession property of another without

SUMMONS, ORDER OF ATTACHMENT, AND NOTICE TO GARNISHEE, FOR TEN PER CENT OF PERSONAL EARNINGS

THE STATE OF OHIO, ... COUNTY, SS.

To Any Constable of .... Township:

You are hereby commanded to summon .... to appear before me, the undersigned, a Justice of the Peace of said County, at my office, in .... Township, in said County, on the ...... day of ...., A. D. 19...., at .... o'clock, .. M., to answer the action of .... who claim of the defendant the sum of $.......... with interest thereon at ...... per cent from the ...... day of ...., A. D. 19...., for necessaries[1] .... furnished said defendant and his family, to-wit:[2] ....

The plaintiff asks judgment for the amount indorsed hereon, and for costs.

You are also commanded to attach the excess above ninety per centum of the personal earnings of the defendant, now due him from .... hereby made garnishee in this action, in a sum sufficient to cover the above claim, and the sum of two dollars and fifty cents, cost.

You are also commanded to notify said .... garnishee, also to appear before me at the time and place above specified, and answer under oath or affirmation all questions put to ...... touching such personal earnings of the defendant, and to disclose truly the amount thereof that may be owing by ...... to the defendant, whether then due or not; and further to notify said garnishee that ...... is held liable to the plaintiff in this action, for the excess over and above ninety per centum of such personal earnings of the defendant, that is now due, and that shall become due from ...... to the defendant, from the date hereof until the final trial and adjustment of the cause for which this action is brought; and, in addition thereto, a sum not exceeding two dollars and fifty cents, to cover the actual costs of this proceeding.

You will make due return on this writ, on the ...... day of ...., A. D. 19....

Witness my hand, this ...... day of ...., 19....

........................Justice of the Peace

1. If so, here write "work and labor," and erase the preceding word, "necessaries."

2. "Groceries [or provisions, or clothing, or whatever other necessaries] furnished the defendant or his family," or "For ...... days" labor, from ...., 19.., to ...., 19.., performed for said defendant at his request," or similarly, as facts may be. As to costs, etc., see §10271 (103 O. L. 567).

Form 18. Notice of Garnishment

fault or blame, and he is supposed to stand indifferent as to who shall receive the money or property. The garnishee in the eyes of the law is a mere stakeholder or custodian of property attached in his hands, and has no right to do any voluntary act to the prejudice of either the plaintiff or defendant in the action. Consequently, the effect of service upon the garnishee is to impound the funds in his hands.

If the garnishee transfers during the pendency of the garnishment proceedings, any of the property or funds in his hands belonging to the principal debtor, he does so at his peril

and is in no wise relieved from liability to the creditor by such conduct, even though it may have been induced by a mistaken idea as to the effect of the writ. However, payment to the debtor before the commencement of garnishment proceedings is proper, even though the future garnishee knew when he made the payment that the creditor was preparing to institute proceedings.

Garnishment process operates only upon such interests of the debtor as exist at the time it is served, and not such as may afterwards arise, according to the statutes and decisions in most states. Consequently, if there is no indebtedness at that time from the garnishee to the defendant, the plaintiff will not be entitled to judgment, although it may appear that between the time of service and answer the garnishee became indebted and paid the debt to the defendant debtor.

Persons Subject to Garnishment

A question whicn often arises is as to whether or not a citizen in one state may garnishee a debt due and payable in another, and if so as to the proper jurisdiction in which to stage the proceedings. A non-resident cannot be garnisheed unless at the time he has in that state property of the defendant in his hands, or he is bound to pay the defendant money or deliver him goods within the state. This exemption likewise applies to a foreign corporation, except a foreign company either doing or qualified to do business in the state.

A corporation is liable to the process like a natural person. However, a corporation cannot be garnisheed merely on evidence that the debtor has been doing work for it, and that the books disclose an unpaid balance in his favor. It must also appear that the balance has become an actual debt against the corporation, and whether the claim still belongs to the debtor, or has been assigned to some other person.

In the absence of statutory permission an administrator cannot be garnisheed, nor can an executor or a guardian, until

his accounts have been adjusted in the probate court and a balance found in his hands. A sheriff, or other officer of the law, cannot be garnisheed as to money in his hands in his official capacity. A receiver, however, is amenable to garnishee process in the absence of statutory provision, and when the process does not tend to disturb his rights under the general orders of the appointing court.

Property Subject to Garnishment

As a general rule, to render a third party liable as garnishee it is necessary that it appear in the garnishment proceedings that the garnishee has in his possession property or credits belonging to the debtor, or that the garnishee is indebted to the debtor, because the creditor stands in the same relative position to the property or funds garnished as the debtor, and consequently can enforce only such derivative rights as were possessed by the debtor. In other words, the garnishee cannot be put in a worse position by virtue of the institution of garnishment proceedings.

A test to determine whether or not a third party is liable as garnishee is whether the principal debtor has a right of action against the garnishee. However, there is an exception to the rule that the garnishing creditor can avail himself only of the legal rights of his debtor against the garnishee, and that is where the garnishee has in his possession property of the debtor which he has received under a fraudulent transfer, for though such transfer is valid against the debtor, the creditor may assert its invalidity and in many instances reach it by garnishment.

The right to reach deposits in bank by garnishment proceedings is generally recognized. As soon as the bank becomes liable to the depositor, the fund in question becomes subject to garnishment, which is sometimes accomplished by first examining the bank under a third party order and then obtaining an order directing the bank to pay the funds over to a receiver.

In the case of property placed in a safety deposit box, garnishment against the bank which is the lessor of the box is a proper remedy, by the weight of authority, though there is a conflict of authority on the point. In such cases the court may cause the box to be opened to determine the garnishee's liability. This is true under a statute requiring a garnishee to answer for any personal property of the defendant under his control. Where the box in the vault can be opened only by two keys—one a master's key in the possesion of the bank, and the other a private key in the possession of the box-renter, it has been held that the garnishee in such a case has control of the contents of the box.

Pledged or Mortgaged Property. The pledgee or mortgagee of personalty cannot be held as garnishee of the pledgor or mortgagor while the property is the subject of the pledge or mortgage. Collateral securities placed in the hands of a creditor are not garnishable. But, in some states, e.g., New York, you can attach the pledgor's interest by obtaining an order directing the pledgee to account for the proceeds of sale and to turn over to the creditor any surplus remaining.

Real Estate. It is generally recognized that an interest in real estate cannot be reached by process of garnishment.

Other Cases

A trespasser in possession of another's goods cannot be charged as his garnishee. A common carrier is not subject to garnishment for goods in actual transit at the time of service of process. Property outside the state cannot be garnisheed. A creditor of a fraudulent mortgagor, however, may reach the property included in such mortgage by garnishing the mortgagee.

Property Must be in Possession of the Garnishee

The property must be in the actual possession of the garnishee, or so within his power and control that he can turn

it over to the court. A mere constructive possession will not suffice. Trust funds in his hands, or money held by him in a fiduciary capacity, cannot be reached. Likewise, property held by an assignee under a valid assignment for the benefit of creditors is not subject to attachment or garnishment for the assignor's debts. A trustee under a deed of trust for the benefit of creditors is not subject to garnishment where it appears that the purposes for which the trust was created have not been accomplished and that after the execution of the trust there will be no surplus in the hands of the trustee. Nor can funds in the hands of a trustee in bankruptcy be garnisheed in a suit against a creditor of the estate.

Only Rights of Defendant against Garnishee Acquired

An attaching creditor cannot acquire through his attachment any greater right to the property or credits attached than the defendant had when the attachment was made, unless he can show some fraud or collusion whereby his rights were impaired. In such cases, the creditor may impeach the transferee's title by showing the transfer was fraudulent.

The creditor's rights are, therefore, subject to any pre-existing contract or indebtedness between the debtor and the garnishee, and if the garnishee has a lien on the property, the creditor can only take the property which is subject to that lien.

Jurisdiction in Garnishment of Debt

As to just what constitutes the necessary legal jurisdiction to give validity to proceedings in the garnishment of a debt is a question difficult of solution in the actual state of authorities. It may be stated generally that the trend of decisions is toward establishing the principle that a debt has, for the purposes of attachment, a situs, and that this situs must be within the jurisdiction of the court where relief is sought. Furthermore, the prevalent view would seem to be that the situs of a

debt for the purposes of garnishment is at the domicile of the debtor, the garnishee.[1]

It has also been held, however, that the situs may be at the domicile of the creditor, and, of course, to attach the debt there, service must also be had on the debtor, who accordingly must be capable of being served at the creditor's residence.[2] If the debt is a judgment debt, it can only be seized at the place where the judgment was rendered, provided, as before, service can be had on the garnishee.

Still another view recognizes that the debt has a situs, and insists that wherever the garnishee could be sued by the creditor the debt may be attached.[3] This far-reaching view, which apparently conceives of the debtor as carrying the obligation with him wherever he goes, is questionable in the light of the other authorities submitted.

Ordinarily speaking, no court can be said to control the debt, which consists in compelling its payment and release, except the court which has jurisdiction over both parties. Consequently, it would seem that application for an order, directing the issuance of garnishee execution should, as a general rule, be made in the judicial district in which the debtor resides.

Garnishee Must be a Third Person

By this is meant that the garnishee must not stand in such a relation to the defendant that his garnishment will be in effect the garnishment of the defendant himself. Therefore, an agent cannot be garnisheed as to funds in his hands for his principal; nor can the cashier of a bank in which a debtor's funds are deposited. In an action against one of a firm, a debtor to the firm cannot be made a garnishee. One having possession of mortgaged chattels as the mortgagee's agent cannot be charged as garnishee of the mortgagor.

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[1] 174 U. S. 710.
[2] 23 So. Rep. 825.
[3] 127 Mo. 242.

Garnishment of Judgment Debts

There is a conflict of authority as to the right to make a judgment debtor a garnishee. It has been held that a judgment debt is subject to garnishee process from the court in which the judgment was recovered but not from any other court.[4] It has also been held that a judgment debtor cannot be garnisheed in any event, because he would be unfairly burdened and exposed to double liability. The force of this argument, however, is very slight where the garnishee process is in the court which rendered the judgment, as the court can then easily protect the debtor, at least before execution has issued. The weight of American authority, however, seems to be in favor of a more liberal view, and a few courts have gone so far as to make judgment debts subject to garnishment in any court.

Effect of a Judgment against a Garnishee

Assuming a judgment has been taken against the debtor for $500 and also against a garnishee for, say, $300, is the debtor still liable to the creditor for the full $500 judgment, or for only the difference between the $500 and the $300 which is owing to the creditor from the garnishee?

As between the creditor and the principal debtor in garnishment proceedings, the effect of a judgment in favor of the creditor is to place the latter in possession of all the rights of the debtor against the garnishee involved in such proceedings, and it is well settled that the satisfaction of a valid judgment against a garnishee operates to merge or satisfy the liability of the principal debtor either *pro tanto* or in full, as the case may be.

Some cases go still further and hold that if the defendant pays into court the difference between the amount of the judgment against the garnishee and that against himself, he is entitled to have the judgment against himself discharged

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[4] 39 At. Rep. 436; 52 Pac. 220.

as satisfied.[5] The substance of this decision is that the judgment against a garnishee is equivalent to a levy on the defendant's property in the hands of the garnishee.

Acceptance of the principle laid down by the court in this case gives rise to speculation as to whether it was ever intended that garnishment statutes should force the party who takes advantage of them to accept the liability of some third party as a substitute for that of his debtor. Exceptions to this view may be found. One court has held that the judgment against a garnishee is in the nature of collateral security for the satisfaction of the principal obligation. In commenting upon the legal significance of such a judgment, the court stated, in its opinion, that "it is subordinate and incidental to the judgment against the defendant, and it is difficult to find any principle by which it could become a ground for discharging his liability." A valid judgment in a garnishment suit, like any other judgment, is entitled to full faith and credit in any other state.

Interrogatories

Provision is sometimes made by statute whereby the plaintiff in garnishment, or third party, proceedings is required to file interrogatories which he desires to have answered by the garnishee as to his indebtedness to the defendant and which the garnishee is required to answer. In some jurisdictions he may be examined orally. If a garnishee fails to appear and answer, the plaintiff may proceed against him in an action in his own name. When sued the garnishee may avail himself of any defense which he might urge in an action brought against him by the defendant debtor.

When the answer of the garnishee on his examination under oath in garnishment proceedings is satisfactory to the plaintiff, the judgment of the court may be taken thereon; but

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[5] 80 N. W. Rep. 345.

when his answer is not satisfactory to the plaintiff, an issue may be made up and tried by a jury as in other actions.

In some jurisdictions a judgment is not rendered against the garnishee. All that the creditor can do is to obtain an order against the garnishee to appear and answer, and upon such appearance, if the debt is admitted, an order may be made for its payment into court; and if the debt is denied, an order may be entered authorizing the judgment creditor to institute an action to recover the alleged debt.

The fact that the principal debtor has made a valid assignment of his claim against the garnishee so that the garnishee is liable to the assignee of the debtor, defeats garnishment proceedings, and the garnishee may in his own defense set up the rights of the assignee to whom he is liable.

Liability for Costs

As a rule the court may allow the garnishee his costs in the garnishment proceedings and in some jurisdictions the court may allow him compensation to meet his expenses, including a reasonable attorney's fee. But if the garnishee denies all liability and the judgment is subsequently entered against him, he may be held liable for the costs.

CHAPTER XXVIII

THE PROVISIONAL REMEDY OF REPLEVIN

Nature

It is too familiar to every credit man to require being formally stated and explained that a breach of contract gives rise to a right of action for damages, but in case of insolvency or fraud a decided advantage would acrue to a seller of merchandise if he were able to reclaim and retake his property, or, as it is technically termed, to exercise a "right of recaption." In chandise if he were able to reclaim and retake his property, or, loss suffered through reliance on a false statement, whether submitted direct to the seller, or through the intermediary of an agent, as the mercantile agencies, such a remedy is often impracticable, because if the financial statement was false and the buyer is unable in fact to pay for the goods, what good does it avail a creditor to have a judgment which he cannot collect?

Object of Replevin

Hence, the justice in giving him the greater right, that of recaption or replevin, under such circumstances is obvious, and in certain cases the law does afford just such a remedy. For instance, as pointed out in Chapter XXV, a seller having shipped goods under a straight bill of lading to a consignee who becomes insolvent after the shipment is made, is given the legal right of stoppage in transitu, or right to stop the goods in transit and retake them from the carrier; and it would seem that the same principles of justice which underlie this right would likewise apply in the analogous case of a shipper consigning goods to a fraudulent buyer, the point in common being

that the prospects of collecting the sale price are very remote in both instances. In fact, the law has so regarded it and provided the same remedy for it. So the general principle of law on the subject may be summed up by saying that even though the seller of goods voluntarily delivers them to the buyer (directly or through an agent), the latter is guilty of a wrongful taking if he obtains them by such fraud as justifies the seller in rescinding or avoiding the sale, and upon its avoidance the owner may insist that no title or right of possession ever passed to the defrauder, and retake the goods, provided he executes a bond, or undertaking, as security to the purchaser against any injustice he may suffer as the result of such action.

Legal Procedure

In actual practice, however, the procedure consists in the owner of the goods applying in the proper court for a writ of replevin (Form 19), and specifying the property he claims and the grounds on which his claim is based. When granted, this writ authorizes and directs the sheriff, or other officer of the court, to seize the property and bring it into court, whereupon

WRIT OF REPLEVIN, WITH SUMMONS

THE STATE OF OHIO, ... COUNTY, SS.
To Any Constable of ...... Township. } Damages claimed, $ ......

You are hereby commanded to summon .... to appear before me, the undersigned, a Justice of the Peace in and for the said County, at my office therein, on the ...... day of ...., 19...., at ...... o'clock .. M., to answer the action of .... for wrongfully detaining the following described goods and chattels of the said .... to wit:

....
....
....
....

You are further commanded immediately to seize and take into your custody, wherever they may be found in said County, the said goods and chattels above mentioned, and keep the same in your possession till further order of this court.

You will make due return of this writ on the ...... day of ...., A. D. 19....

Given under my hand, this ...... day of ...., A. D. 19....

....................Justice of the Peace

Form 19. Writ of Replevin

the possessor (the one from whom the property has just been taken) is given the privilege of what is known as "bonding back" the property, by giving security for its return in event it is decided that he is not rightfully in possession of it. In this way the rightful owner is protected against any loss, misuse, or conversion of the property, pending a decision as to the merits of his claim.

In other words, a creditor's right of replevin is the proper remedy to regain possession of goods which have been wrongfully taken or acquired from the possession of the creditor, and which he claims as the rightful owner. Where a portion of the property cannot be replevied because the defendants have destroyed, concealed, or sold such portion, the plaintiff may replevy such portion of the property as can be found and maintain a separate action to recover the value of the rest.

Originally it was necessary to prove not only the wrongful possession of the goods, but that there had been a wrongful taking or seizure, or that the defendant had come into possession of them unlawfully. But in most all the states this rule has been modified, and replevin, when allowed at all, lies for a wrongful detention or withholding of the goods by one who, in the first instance, came into possession of them lawfully. Thus the action will lie for goods wrongfully detained by a fraudulent purchaser, or against any other person in whose possession personal property which has been unlawfully taken is found.

A judgment in replevin, where there is no assessment of damages, merely determines the right of possession.

Right to Possession Necessary

To maintain such an action the plaintiff must have a present right to immediate possession of the property. In other words, it is not sufficient for the plaintiff in replevin to have a clear legal title to the property in controversy; he must also be entitled to the immediate possession; e.g., in an action by a

mortgagee to obtain possession of mortgaged personalty, an allegation that the goods were mortgaged to him was held insufficient as not showing who was entitled to possession.

Assuming a trade acceptance to have been tendered in payment for the goods, it has been held that if the seller retains possession of the trade acceptance, or if he is able to render return of the instrument, he does not lose his right of replevin. Tender of the instrument is necessary, however, to maintain this right.

What Property May and May Not be Replevied

The owner of property wrongfully taken may pursue it so long as it may be identified, regardless of whatever alteration in form it may assume, unless it has been annexed to, or become a part of, some other commodity. Furthermore, a purchaser from the defendant of property which is the subject matter in an action for replevin, who purchases with notice of the litigation pending, buys at his peril, and if judgment is afterwards rendered against the defendant it becomes the duty of the sheriff to take the property from such purchaser notwithstanding the fact he may have paid full value for it.

Suppose goods are conditionally sold and then removed by the purchaser from the place where they were to remain until paid for. The seller has a right to replevy the goods.

Replevin will lie for choses in action, such as notes, checks, bonds, etc., as well as for goods, wares, and merchandise.

Demand—When Necessary

Where the goods come into the defendant's possession without any wrongdoing on his part, a demand for the return of them is essential, and the action will not lie against a purchaser in good faith from a wrongful taker until after such a demand has been made. But a demand is not necessary where the taking was wrongful; for example, where the defendant purchased the goods with knowledge that the party who sold them

had obtained them by fraud. Where goods are delivered by mistake to one who has no right to the possession of them, and he, instead of endeavoring to correct the mistake, retains possession and claims a lien upon them, the owner may regard him as a wrongdoer and maintain an action against him without demand.

A consignee of goods sent C. O. D. cannot maintain replevin against the carrier before payment and delivery. A tender of the purchase money and demand for the goods are essential to replevying the goods under circumstances such as these.

Defenses

An action of replevin is barred by any proof that the plaintiff, when he began the suit, had no right to the possession. For example, an action to recover possession of personal property may be defeated by showing that the defendant has been required to deliver the property to a third person entitled to its possession. However, the mere fact that title to the property is in a third party, or that some third party has a lien on the goods, is no good defense; the plaintiff in such instances simply takes subject thereto.

Damages

The primary purpose of replevin is to recover the property in specie and not its value. The defendant, however, has his election to deliver the property specified in the writ when the sheriff calls for it, or to retain it by giving a security bond. If the property be surrendered, the defendant is still answerable in damages for the taking and detention of it up to the time of delivery. If retained, he is liable, in addition, for the full value of the goods, and in no event can the property itself be recovered from the defendant; nor can he tender it afterwards in discharge of the action.

The measure of damages where the property cannot be

returned is the value of the property at the time it was replevied plus damages for the injury sustained.

The Bond

The plaintiff in an action of replevin is required, as a prerequisite to the service of the writ, to give a bond of indemnity with sureties to return the goods if a return be ordered, or to pay all costs and damages resulting from the wrongful suing out of the writ. The amount of the bond is always at least double the value of the property or goods.

CHAPTER XXIX

THE BULK SALES LAW

Sale of Goods in Bulk

Another statutory aid that has been devised to protect creditors against fraud on the part of their debtors is commonly known as the "Bulk Sales Law." Such statutes have been enacted in all of the states. They are practically similar and have been given similar force and effect by the interpretations placed upon them by the courts.

Two concrete examples will serve to illustrate the general situation with which these statutes have to deal:

> 1. Suppose A is a wholesale grocer carrying a stock of goods valued on his property statement at $2,000, and on the strength of which you as a credit man have extended him credit and filled his orders up to $500. The next information you receive regarding A is that he sold out his entire stock of goods to B, a bona fide purchaser for value, last week for $1,500, purchased an automobile, and in learning to run it met with an accident in which the car was totally wrecked. Ordinarily, in the absence of some special statute, as a creditor of A you would have no claim against B personally, or against the goods he purchased from A. Your only claim was against A personally, who now has no other assets over and above his $500 legal exemption.

The opportunity presented by such a situation for the perpetration of fraud is readily apparent, and before the enactment of the Bulk Sales Law it was not an uncommon practice for dishonest debtors, in an attempt to defraud their creditors, to sell their entire stock in bulk at a quick sale and at a low valuation, and then dissipate or conceal the proceeds.

> 2. Suppose that instead of selling the goods in bulk to some third person, the business of the individual merchant or partner-

ship is incorporated and the entire property of the merchant transferred to the corporation in exchange for corporate stock.

In so far as the rights of creditors in the stock of the merchant are concerned, they are cut off just as completely and effectively as in the first case, where the goods were sold outright.

Purpose of Law

It is obvious that there should be some means to prevent such a sale or transfer being consummated without giving the creditors an opportunity for self-protection against such a contingency, for in granting mercantile credit it is generally assumed as a matter of fact that the customary methods of trade will be followed by the merchant and that the debt thus incurred will be paid from the proceeds derived from the sale of the goods in the ordinary course of business. It therefore constitutes a breach of good faith when the merchant totally disregards that which is justifiably expected of him and disposes of his goods in bulk in such manner as to preclude any claim whatsoever by the creditor against the stock after it is sold. For if the seller had anticipated any such deviation from the usual course of business and that the goods would be sold in bulk to a single purchaser, the order doubtless would not have been filled, because the fact that the merchant has his present reputation to protect as a safeguard of his future success is one which enters largely into the question of selling goods on credit.

It was this general situation which gave rise to the enactment of what is known as a "Bulk Sales Law" in every state in the Union,[1] and while the laws of the different states vary in their formal requirements, the substance of all of them is practically the same. Consideration of the Bulk Sales Law of

[1] The purpose of these statutes has been stated to be as follows:

"The object of the Act was to suppress the wide-spread evil and practice of merchants who are heavily in debt from making secret sales of their merchandise in bulk for the purpose of defrauding their creditors." (Wright v. Hart, 182 N. Y. 330.)

New York will, therefore, serve our purpose quite as well as that of any other state. It provides that:

> The sale, transfer or assignment, in bulk, of any part of the whole of a stock of merchandise, or merchandise and fixtures pertaining to the conducting of said business, otherwise than in the ordinary course of trade and in the regular and usual prosecution of the business of the sellers, transferrer or assignor, shall be void as against the creditors of the seller, transferrer, assignor, unless the purchaser, transferee or assignee demands and receives from the seller, transferrer or assignor a written list of names and addresses of the creditors of the seller, transferrer or assignor, with the amount of the indebtedness due or owing to each and certified by the seller, transferrer and assignor, under oath, to be a full, accurate and complete list of his creditors, and of his indebtedness; and unless the purchaser, transferee or assignee, shall at least five (5) days before taking possession of such merchandise, or merchandise and fixtures, or paying therefor, notify personally, or by registered mail, every creditor whose name and address appears in said list, or of which he has knowledge, of the proposed sale and of the price, terms and conditions thereof.
>
> Sellers, transferrers and assignors, purchasers, transferees and assignees, under this act shall include corporations, associations, co-partnerships and individuals, but nothing contained in this act shall apply to sales by executors, administrators, guardians, receivers, trustees in bankruptcy or by any public officer under judicial process.
>
> Any purchaser, transferee or assignee, who shall not conform to the provisions of this act shall at any time within ninety days after such sale upon application of any of the creditors of the seller, transferrer or assignor, become a trustee and be held accountable to such creditors, for all the goods, wares, merchandise and fixtures that have come into his possession by virtue of such sale, transfer or assignment, provided, however, that any purchaser, transferee or assignee, who shall conform to the provisions of this act shall not in any way be held accountable to any creditor of the seller, transferrer or assignor, or to the seller, transferrer or assignor for any of the goods, wares, merchandise or fixtures that have come into the possession of said purchaser, transferee or assignee by virtue of such sale, transfer or assignment.

Such legislation applies only to business men who are engaged in the retail trade.

Question of Constitutionality

In several instances (Ohio, Utah, New York, and Illinois) such a law when passed by the state legislature had at first been declared unconstitutional by the state courts on the grounds that it constituted legislation in restraint of trade and unlawfully restricted the right of contract and the disposition of one's property. Later enactments in these states have been upheld by the courts.

In declaring the first Ohio law unconstitutional,[2] the court in its opinion stated:

> The United States Constitution guarantees the right of the individual to acquire, possess and enjoy property with all of its incidents and attributes, and it is the duty of the judicial department to shield that right from legislative encroachment. . . . . .
>
> For every restriction upon the enjoyment and use of property there must be substantial reasons of a public character. If a restriction is placed upon the alienation of property, it must be for the entire body of the people, or at least, of all who are within the reason of its restriction. A distinction sometimes thought important between property in land and in chattels upon the ground that the former is derived from the state, will at least justify the conclusion that legislative control over chattels is not greater than over lands. The express limitations which the Constitution imposes upon the legislature apply to the exercise of powers which are truly negative in character, and since none but legislative power is committed to it, the exercise of that power is also confined within all the limitations which are suggested by its nature.
>
> Applying the familiar and unquestioned rule that the validity of an Act is to be determined by its practical operation and not by its title or declared purpose, this Act under guise of preventing fraud in such sales, prohibits them altogether, and this places on the enjoyment of property an important restriction which no public interest requires and which the Constitution therefore

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[2] Miller v. Crawford, 70 Ohio 207.

> forbids. One who challenges the soundness of this conclusion should be prepared to maintain the validity of an Act expressly forbidding sales of stocks of merchandise in bulk. By the Act the legislature has attempted to discriminate unwarrantably among debtors and creditors. It does, in liens, apply to sales in bulk by wholesale as well as by retail dealers in merchandise. But conceding for present purposes, that when reasons for legislative discrimination exist, then sufficiency is to be determined finally by the legislature; no reason is suggested by counsel, nor does any occur to us, for a legal discrimination in the relation of debtor and creditor between those who come into that relation with respect to the purchase and sale of merchandise, and those between whom it exists with respect to chattels in general. Although the Act applies to all creditors of the seller, it applies to those only who are creditors of the owner of a stock of merchandise, and thus an unreasonable burden is imposed upon a limited class of debtors for the supposed benefit of a limited class who are creditors.

In commenting on the constitutionality of the later New York statute, Justice Johnson of the Supreme Court said:

> It is a matter of common knowledge that the business of retail merchandising is conducted largely upon credit. This system has come about as a natural outgrowth of the vast increase in the facilities of transportation and communication in modern times. It was not surprising that a system, so built up and conducted, should be attended with abuses, for it furnished an opportunity for the commission of frauds upon creditors not usual in other forms of business. There was a temptation to sell stocks in bulk without providing for the payment of creditors from whom they were bought. It was natural and inevitable that such an important subject should be called to the attention of the legislatures and courts.
>
> We think it clear that there are substantial reasons for the classification made by this statute. It applies equally to all merchants having a stock of merchandise for sale in the usual course of trade who have creditors. It operates upon such class when there is contemplated a bulk sale of the stock otherwise than in the ordinary course of trade. It relates to all purchasers. It affects all within the class of creditors of such merchants. The necessary results of its operation would be in the interest of honest

merchants and of the public welfare, for these are concerned in the prevention of frauds and in the protection of public morals. . . . .

Creditor's Remedy for Violation

Perhaps the most important uniform requirement of these statutes is that the buyer must notify the creditors of the seller that the sale is to be made, and, assuming that proper notice has been given by the purchaser, the purpose of the law is to afford the creditors a reasonable time in which to attach the merchandise, stock, or fixtures, or resort to any other form of legal process competent to recover the assets for the payment of their claims.

On the other hand, if the statute has not been complied with, and no such notice is given by the purchaser, the creditor's remedy is by way of application to the court for the appointment of a receiver to take over the property which has been transferred; or by setting forth the facts and requesting that the purchaser be declared a trustee of the goods for the benefit of the creditors of the seller. If the application is granted an appraisement of the property is made, which is then sold, the proceeds being applied in payment of the creditors of the original seller. Such a petition to the court must, as a rule, be made within 90 days subsequent to the transfer of the goods or property.

Protection Afforded

The chief obstacle encountered in the prosecution of fraud in any form is the difficulty in substantiating the necessary allegation of fraudulent intent, and the practical value of the Bulk Sales Law to a mercantile creditor in seeking to set aside sales of goods as fraudulent lies in the fact that it places the burden of proof upon the defendant. The creditor is merely obliged to show that the sale took place without conforming to the requirements of the Bulk Sales Law, in order to raise a presumption that the sale was fraudulent and thus shift

the burden of proof to the defendant, who is then obliged to prove that the sale was bona fide.

Practical Application

The enforcement of the Bulk Sales Law varies in some states in accordance with the statutes pertaining to attachments, garnishee process, and other provisional remedies of an unpaid creditor. A typical case, however, would be for the commencement of an action by the creditor against the debtor and the purchaser of goods in bulk, in which case an attachment or garnishee process would be issued, setting up fraud in that the terms of the Bulk Sales Law were not complied with. Armed with this process, the sheriff, or other appropriate officer, seizes the goods thus sold in bulk from the possession of the purchaser and holds them to await the outcome of the trial of the action. In that action the creditor merely shows that the debtor sold his stock without complying with the act, and this creates a prima facie case in support of the creditor's contention that the sale was fraudulent. If the debtor or the purchaser of the goods in bulk is unable to show that he gave full value for the property, and had no reason to suppose that the property was being disposed of for the purpose of defrauding creditors, the plaintiff would win his action and the sheriff would turn over the goods or the proceeds from their sale at auction to him under the execution issued upon the judgment.

If, on the other hand, the purchaser of the goods in bulk succeeded in showing that the purchase was made by him for approximately fair value, without fraud of any kind, the attachment would be vacated and the creditor would lose his case, except in those states where sales in bulk are declared absolutely void for non-conformity with the statute.

In the latter case, assuming that the proper notice has been given by the purchaser under the Bulk Sales Law and the money paid over, but the possession of the merchandise not

taken at the end of the fifth day, the creditors may attach the merchandise, stock, or fixtures, or use any other legal process competent to preserve the assets for the payment of their claims. If possession of the stock has been taken in less than five days, the notice duly given by the purchaser under the Bulk Sales Law, and the money was held until the end of the five days, the creditor may then subject[3] the money in the hands of the purchaser to the payment of his claim.

In states where the sale is by statute made absolutely void for non-conformity, the creditor is merely obliged to prove that the sale took place without conforming to the requirements of the Bulk Sales Law to be set aside by a decree of the court, whereupon the property becomes subject to levy in the hands of the purchaser under an execution against the seller.

When Statute Is Applicable

To come within the statutory provisions of the Bulk Sales Law, the sale must be "in bulk," of "the whole or a major part," or "more than half" of a stock of goods or merchandise, and must be made otherwise than in the ordinary course of trade and in the regular and usual prosecution of the seller's business. The question as to whether a sale was made in the ordinary course of business, or whether an unusual method of disposing of the stock of goods was employed is essentially one of fact, depending upon the nature of the seller's business.

The inadvertent omission of the name of one or a few creditors from a list of creditors presented by the seller to the buyer in accordance with the statutory requirements, or the failure of the purchaser acting in good faith to notify a single creditor or a few creditors of his intention to purchase the goods, has been held not to give ground for holding the sale fraudulent and void.

[3] See circular of National Association of Credit Men.

Store fixtures do not constitute part of a stock of goods within the meaning of the statutes, but are specifically included in most states.

Methods of Evasion

Evasion of the law has been attempted by having the seller execute a chattel mortgage, fail to record it, and then subsequently release his equity of redemption to the purchaser. The effect of the release given under such circumstances is to transfer an absolute legal title to the previously mortgaged goods to the purchaser, and it has therefore been held to constitute a "sale" within the meaning of the Bulk Sales Law.

Another method of evading the law, and one which has proved successful, provides for a double transfer of the goods, e.g., a sale is first made by A to B, and then a resale made by B to C, the transfer in both instances being without notice to the creditors of A, who in such a case have been denied recourse to the goods in the hands of C, the court holding that the law requires notice to be given only by the immediate vendee of the transferrer.[4]

Tabular Analysis of the State Statutes

The Bulk Sales Laws of the different states may be classified into three groups, in accordance with the effect a noncompliance with the statutory requirements has upon the validity of the sale. The first group consists of some 16 states wherein the failure to comply with the statute renders the sale absolutely void, and the goods are subject to attachment in the hands of the transferee under a writ of execution against the property of the seller. These states are the following:

Arizona
Arkansas
Colorado
Connecticut
Indiana
Iowa

[4] See Credit Men's Manual of Commercial Laws, p. 108.

Kansas	New York
Maine	North Dakota
Maryland	Ohio
Michigan	Texas
Nebraska	Virginia

In the following 20 states the statute provides that the effect of non-compliance with the statutory requirements is to render such sale or transfer both void and fraudulent:

California	New Hampshire
District of Columbia	New Mexico
Idaho	Oregon
Illinois	Pennsylvania
Kentucky	Rhode Island
Massachusetts	Utah
Mississippi	Vermont
Missouri	Washington
Montana	West Virginia
Nevada	Wisconsin

In the following 12 states the effect of non-compliance is to create a presumption that the transfer was fraudulent and void; but in the absence of proof of fraud, a sale in disregard of the statute will not be set aside:

Alabama	New Jersey
Delaware	North Carolina
Florida	Oklahoma
Georgia	South Carolina
Louisiana	Tennessee
Minnesota	Wyoming

CHAPTER XXX

COMMERCIAL FRAUD

> Get a reputation for giving full measure, for being generous in times of pressure and panic, and for charity towards misfortune, but by all you hold sacred or holy, get a reputation for getting the last ounce of flesh from the man who tries to "do" you in any manner, shape, or form.

Reluctance to Prosecute for Fraud

Lawsuits of any nature are distasteful to business men, who as a rule take advantage of any proper way to avoid them. They extend over too long a period, cost too much money, their results are too uncertain, and in a way they reflect upon the manner in which a man's business is conducted. For this reason business men as a rule are too prone to enter into compromise settlements as the path of least resistance out of an otherwise difficult situation; but it is unquestionably a mistake to enter into such a settlement when any suspicion of fraud is present, because so long as your claim remains unpaid, you hold a club over the debtor's head, which is often valuable in placing a dishonest debtor behind the bars.

There is also another very good reason why the number of prosecutions for commercial fraud is limited—simply because there is a large class of technical frauds for which the law affords no legal remedy. In fact it is surprising, and at the same time discouraging from a credit man's viewpoint, to see the extent to which a certain class of unscrupulous tradesmen with which the business world is infected, can go in the way of sharp practice and still remain "within the law." Moreover, in many instances where the law does afford a remedy the prosecution is so fettered by legal restrictions in the nature

of technical rules of evidence as to render conviction doubly difficult, inasmuch as a preponderance of evidence in civil suits suffices for the prosecution to prove its case, whereas in criminal cases it is necessary to establish one's case beyond any reasonable doubt to obtain a conviction.

What Constitutes Fraud

Fraud, as a generic term, is legally defined as consisting of "(1) any artifice or deception practiced to cheat, deceive or circumvent another to his injury; (2) any act, omission, or concealment that involves a breach of duty, trust or confidence, and which is injurious to another, or by which an undue advantage is taken of another."

Practically, however, there are two kinds of fraud—civil and criminal—depending on the nature of legal redress afforded. The former class consists of deceitful practices which do not reach the gravity of criminal fraud, and give rise to a right of action for damages, while the latter class, with which we are here concerned, consists of practices of a more serious nature for which punitive measures have been provided.

Practical Difficulty Encountered in Criminal Prosecution

To illustrate the difficulty encountered in criminal prosecution, let us examine the elements or requirements necessary to establish a case under the False Statement Law:

1. The statement "must be in writing." Should I drop in your office and tell you that my business assets amount to $20,000, liabilities to $11,000, and working capital approximately to $6,000, on the strength of which you extend me credit up to $500, you could not prosecute me under this statute (unless it so provided).

2. The "statement" must be false, as ostensibly showing his actual condition "as of a certain time." Hence the importance of the date on which the statement was made up.

3. The statement "must have been known to be false by the

maker." A person who innocently, or thoughtlessly, makes a misrepresentation is guilty of no crime, even though his representation may result in loss to others. He must either know it is untrue, or have been "criminally negligent" in not verifying it before it was sent out. "Bad faith" is the very essence of this requisite.

4. The statement must have been made "with intent to be relied on" or "to defraud." If it is made to someone merely with a view, or intent, to mislead him, or as a means of evasion of some personal inquiry as to the true condition of your business affairs, you are not guilty of any crime because the misrepresentation must have been made with intent to defraud. In case of mistake there is practically no redress, although the law does provide some remedy of a civil and criminal nature where money or property has been obtained under false pretenses.

5. The statement "must be acted on" or the "creditor must have relied on the misrepresentation in extending the credit." For example, suppose A has made a false statement to procure credit; if the seller did not rely on that false statement, but made inquiries through other sources, and depended solely and entirely on the information obtained through this supplemental investigation, A is not liable. The false representation must have been relied on exclusively or in part to be taken advantage of in maintaining such an action. "The law was intended to be used as a shield, not as a sword."

6. "The creditor must have suffered damage or loss as a result of it," for in such cases recovery is allowed as compensation for the injury suffered, and a penalty to prevent the recurrence of the wrong. The test is: Was the plaintiff injured; and, if so, to what extent?

Such difficulties encountered in the prosecution of commercial fraud naturally lead to speculation as to whether the criminal laws on the subject are not too strict in their requirements for the good of the commercial world, which is

quite a different question from asking why a larger percentage of the perpetrators of fraud are not "sent over the hill."

What change or reform has taken place in criminal law seems to have been brought about with a view to bettering the social welfare of humanity and with no particular regard to the incidental aspect of commercial justice. For example, in England coercion was at one time practiced as a means of recovering hidden property, and imprisonment was the prescribed remedy for debt, but today imprisonment is almost universally provided for only in aggravated cases of fraud.

Without dwelling further on the merits of this transition, the effect of the change has unquestionably been to encourage sharp practice in business, and the laxity afforded has certainly been indulged in by that class of tradesmen (fortunately small) who do not hesitate to reap a profit at your expense, and to evade, when possible, the payment of their honest debts in the nature of business obligations.

This is particularly true as applying to insolvency legislation and the leniency afforded those who have purposely placed themselves in a position where they are unable to pay their debts. The point in this connection has been well put by Mr. Mill when he states:

> It is the business of law to prevent wrongdoing, and not simply to patch up the consequences of it when it has been committed. The law is bound to take care that insolvency shall not be a good pecuniary speculation, that men shall not have the privilege of hazarding other people's property without their knowledge or consent, taking the profits of the enterprise if it is successful, and if it fails, throwing the loss upon the rightful owners; and that they shall not find it answers to make themselves unable to pay their just debts, by spending the money of their creditors in personal indulgence. It is admitted that what is technically called "fraudulent bankruptcy," the false pretense of inability to pay, is, when detected, properly subject to punishment. But does it follow that insolvency is not the consequence of misconduct because the inability to pay may be real? If a man has been a spendthrift, or a gambler, with

> property on which his creditors had a prior claim, shall he pass scot-free because the mischief is consummated and the money gone? Is there any very material difference in point of morality between this conduct and those other kinds of dishonesty for example which go by the names of fraud and embezzlement?

This should in a measure explain and account for the apparent apathy on the part of business men in general, and credit men in particular, towards the prosecution of fraud; and so long as it is the desire on the part of merchants to combat commercial fraud, but no special effort is made to do so, the effect is both weakening and detrimental to mercantile interests. Furthermore, so long as this state of affairs continues, the only sources through which the prosecution of this unscrupulous class of merchants seems likely to be accomplished are the national and local credit men's associations. The former has appropriated quite a large fund for the purpose, and while it will have to be more or less cosmopolitan in carrying on its campaign, a striking example here and there should, with proper publicity, have a very salutary effect in general.

Criminal Prosecutions No Bar to Civil Action for Damages

There is still a very important point to be brought out in this connection. If the concern with which you are connected has been defrauded, for instance, through a forced reliance on misrepresentations which were knowingly made to you by the party with whom you were dealing, remember that a prosecution of the crime can be instituted in the criminal courts, and if there are any assets available you can also sue in the civil courts for the recovery of your money. At first, exception was taken to such procedure on the constitutional ground that "a man cannot be placed in jeopardy twice for the same offense," but it has been held that one act may constitute two separate offenses in that: (1) it may violate a particular civil right, or obligation of a certain individual or individuals, and (2) affect, or violate, the rights or welfare of society in gen-

eral. Our legal system affords a remedy by civil suit for damages or compensation for the former, and a penalty in the nature of punishment as a deterrent against a repetition of the latter.

Criminal Statutes

In most states the old common law has been superseded by statutory law, wherein an act is not a crime unless specifically made so by statute; and just as the constituents of the legislatures of no two states are the same, likewise the criminal statutes are not the same. It is not to be inferred from this that each state has a different code of morals from the other; the variation is not so radical as this. The same standards are common to all, and the variations constitute the exception, one of which happens to be the very subject we have been dealing with. In some states they have no such law; in others the statement may be made either orally or in writing, whereas in still others it *must* be in writing to come within the statute.

> It is the duty of the prosecuting attorney to prosecute criminals, and when you have been cheated or defrauded in violation of the criminal law, you ought to prosecute relentlessly even though your prosecution results in some temporary financial loss to yourself. If credit men in general will do this—will let the criminally inclined know that money is no object to them when those with whom they are dealing have violated the law—the practice of obtaining money or goods under false pretenses would soon cease, and the district attorney's office would no longer be needed as a collection agency.[1]

Furthermore, when you attempt to compromise a crime and dismiss a case once instituted, on recovery of your money, you are either compounding a felony or a misdemeanor, or you are guilty of extortion, and this is something that is not always realized by those who seek to use the district attorney's office as a medium for the collection of their debts, but it is the case nevertheless.

From an address by W. T. Ford, former District Attorney of Los Angeles.

CHAPTER XXXI

CARRIER'S LIABILITY FOR GOODS IN TRANSIT

Private Carriers

The general term "carrier" is defined as one who undertakes to transport goods from one place to another. This service may be performed either by: (1) one who makes a regular practice or business of so doing, or (2) by one who undertakes to do it only in a specific instance.

The private carrier, unlike the common carrier, does not hold himself out as being ready and willing to serve indiscriminately all who apply, but only in accordance with the special contracts which he enters into in individual cases. He is therefore permitted by law to "pick and choose" as to those with whom he will do business. He is vested with no exceptional rights, neither does he incur any exceptional responsibilities over and above the duty to exercise ordinary care and diligence in performing his undertaking by which is meant such care and diligence as would ordinarily be exercised by the average prudent man.

Unlike the common carrier, the private carrier of goods is not an insurer of the goods unless he has made himself so by special contract. Consequently, he is therefore liable for the loss of, or damage to, the goods only when it is due to his negligence. It has also been held that he may bargain away this responsibility by stipulating that he shall in no event be liable except in case of fraud or its equivalent.

Common Carriers

A common carrier of goods is one who undertakes to carry goods for hire for whomsoever may employ him. Whether

one is a private or common carrier depends primarily on his holding out. If he purposes to serve all who apply indiscriminately, he is a common carrier. It has accordingly been held that ferrymen, bargemen, lightermen, and owners of river and canal boats are common carriers of goods; also proprietors of land vehicles, such as express companies and railroads.

Liabilities of Common Carrier

The most important duties and liabilities imposed by law upon the common carrier of goods have been classified as:

1. His duty to carry for all.
2. His duty to furnish equal facilities to all.
3. His liability for the loss of, or damage to, the goods.
4. His liability for deviation and delay.

Duty to Carry for All

One of the obligations of a common carrier is to carry goods for any and all persons properly tendered to him for transportation, subject to the following limitations:

1. The nature of his holding out.
2. The extent of his facilities.
3. The nature and condition of the goods.
4. The payment of his charge in advance.

Except as modified to this extent, a common carrier may be held liable by the intending shipper for any damage resulting from such refusal. It has also been held that an injunction will issue to compel the common carrier to accept and transport goods which have been properly tendered to him.

Nature of His Holding Out

As the common carrier's duty is coextensive with his holding out, he is not obliged to accept goods of a kind he does not purport to carry nor for carriage over any other route, nor by any other means than those indicated by the true nature of his holding out.

Limited Facilities

As for the limitation afforded by his carrying facilities, the old rule was that the carrier's duty is strictly limited by his available facilities, however insufficient they were. The present doctrine, however, requires the common carrier of goods to provide sufficient facilities to handle all the traffic that can reasonably be anticipated. For his failure to do so the carrier is correspondingly liable to the shipper for damages. Nor can the carrier plead limited facilities for his failure to accept and transport the goods tendered. The nature and extent of the equipment which the carrier must furnish is accordingly based on, and determined by, the reasonable demands of the traffic under the particular conditions in question.

But the carrier is not required to provide facilities adequate for any demands that may be made upon him, and particularly is he excused from liability for his failure to provide for an unusual influx of goods—an unexpected accumuiation of freight or an extraordinary press of business. But if the carrier by the exercise of due diligence could have provided adequate facilities to handle the additional business, then he should not be excused for his failure to make the proper arrangement.

Goods Unfit for Shipment

The common carrier is not obliged to accept for transportation goods of a dangerous nature, or goods in such condition as to be unfit for shipment. The high degree of responsibility imposed upon a common carrier is the reason for this, and the carrier is thus justified in refusing to receive such goods for transportation. Ordinarily, however, he has no right to insist upon being informed as to the nature of the contents of goods offered him for shipment. Likewise, the common carrier may refuse to accept for transportation goods unfit or improperly packed for shipment.

Right to Demand Payment in Advance

It is well-settled law that the common carrier may refuse to carry the goods offered unless the transportation charges are paid in advance. In other words, since the law compels the common carrier to accept goods from the public indiscriminately, it also insures him against the incurrence of loss in conforming to the duty by demanding payment of his compensation in advance. If such prepayment is not made on demand, the carrier is then under no obligation whatsoever to transport the goods. The money is not required to be paid down, however, until the carrier receives the goods which he is bound to carry. The carrier should therefore first accept the goods, and then demand payment as a condition precedent to transporting them.

Equal Facilities to All

The common carrier must serve the public impartially and without any preference or discrimination among shippers as to the facilities which are furnished, the rates that are charged, or the rapidity of transport. The service must be disinterested with nothing in it of favoritism. This applies to the element of time as well as to the facilities. Shippers should be served in the order of their application. Consequently, by withholding cars from one shipper and supplying them to a subsequent applicant, the duty to render impartial service is violated.

Liability for Loss or Damage to Goods

The law places upon a common carrier an absolute liability for the loss of, or damage to, goods entrusted to it for transportation, except that caused by:

1. An act of God (storms, floods, hurricanes).
2. The public enemy.
3. The act of the shipper.
4. Public authority.
5. The inherent nature of the goods.

Even when the loss is caused by one of these excepted perils, he is nevertheless liable if he fails to use reasonable care either to avoid such peril or to minimize the loss after the goods are actually exposed to it.

By "act of the shipper" is meant those cases in which the damage resulting is directly due to the fault of the shipper. If the carrier is misled to the extent of being deceived by the shipper as to the real value or nature of the goods, his liability is limited accordingly, inasmuch as the carrier's rate of compensation, and the precaution taken to safeguard the goods, are directly dependent upon their value and nature.

As for loss resulting from negligence in packing or marking the goods, the rule has been laid down that the carrier is not liable for loss or damage resulting from the fault or negligence of the shipper, or the improper performance of any duty which the latter voluntarily assumes.

Liability for Deviation and Delay

When the carrier without necessity or reasonable excuse deviates from the usual or agreed route, he becomes absolutely liable for the goods without any exception whatsoever, on the ground that such an assumed unlawful dominion over the goods constitutes a conversion. But in the absence of special contract, the common carrier is bound to use only reasonable care or ordinary diligence in completing the transportation without delay. The carrier is therefore liable for delay only when it is due to his negligence. If, however, the carrier specially agrees to transport or deliver the goods within a prescribed time, he is bound by his contract, and is consequently liable for his failure to do so.

Liability under Special Contract

Although the general liability imposed by law upon the common carrier of goods is that of an insurer, it is possible for the carrier, by special contract, to limit his liability to the loss

or damage resulting from his negligence. In such a case the shipper makes out a prima facie case of liability against the carrier by proving the loss or injury to the goods, and the burden of proof then rests on the carrier to prove that the loss or damage did not result from negligence on his part.

But the limitation of the carrier's liability as an insurer of the goods can be effected only by means of a contract assented to by the shipper. Notices limiting his liability as such are ineffectual unless the shipper assents to the terms of such notice, and such assent cannot be inferred merely because the shipper, after he has knowledge of the notice, delivers the goods to the carrier for shipment.

On the other hand, whereas the limitation of the carrier's liability must be by contract, it is not essential that the contract should be in any special form. For example, acceptance by the shipper of a bill of lading, or similar instrument, purporting generally to contain the contract between the carrier and shipper, creates a contract binding on both parties. Express receipts stand upon the same general footing as bills of lading, and when accepted without objection, they, too, constitute the contract between the parties. In fact, the practice of incorporating the term of shipment in such receipts has become so general that they are no longer distinguishable in this respect from bills of lading.

Contracts limiting the general liability of the carrier are construed strictly against the carrier. Where the carrier seeks to escape liability on the ground that the loss or injury to the goods was due to causes as to which he is exempt under the contract, the burden of proof rests upon the carrier to bring such loss or injury within his contractual exemption.

Absolute Liability for Negligence

Whereas the carrier may, by contract, limit his extreme common law liability, whereby he was held liable as an insurer of the goods, it is equally clear that the carrier cannot by con-

tract relieve himself from liability for loss or damage due to his negligence, or that of his agents or servants, on the ground that the public nature of the employment is such as to render such contracts contrary to his fundamental obligation to the public, and therefore against public policy.

Stipulations limiting the recovery for loss or damage to a specified amount are clearly valid in the absence of negligence on the part of the carrier or his agents. But where the loss is due to the carrier's negligence, such limitations are invalid. In other words, in such a case the shipper may, in spite of the stipulation limiting the carrier's liability to an arbitrary amount, recover the full amount of damage that has been suffered as the result of such negligence.

Limitation as to Time in Submitting Claims

The carrier may by contract require that claims for damages be presented in a certain prescribed manner, and within a specified time, and the contract will be valid, provided such stipulation as to time and manner be reasonable.

Commencement and Termination of the Liability

The extraordinary liability of the common carrier of goods attaches only from the time when the goods are delivered to, and accepted by, the carrier for immediate transportation. The acceptance of the goods may be implied, although generally express, as where the goods are left in a certain place in accordance with the contract of the carrier thus to receive them, or in accordance with an established custom or usage. Proof of delivery and acceptance by the carrier may be made by any available means sufficient to support the action. Such evidence, however, is usually incorporated in the bill of lading acknowledging receipt of the goods.

The common carrier's liability is terminated when the transportation is completed and the carrier has delivered the goods either to the consignee or to a connecting carrier in

accordance with the terms of the contract. To constitute a valid delivery the goods must have been delivered

1. To the proper person.
2. At a proper time.
3. At the proper place.
4. In a proper manner.

The common carrier of goods is an insurer as to the delivery of the goods to the person to whom they are consigned, and for any mistake in this respect the carrier is absolutely liable, regardless of the question of the care or diligence he has used.

The carrier's liability as an insurer of the goods continues only so long as the goods remain in transit, and thereafter his liability is that of a warehouseman. In the case of carriers by water, the transit has been held to be terminated after the goods have arrived at destination, notice of such arrival has been given to the consignee, and a reasonable time has been granted him within which to receive the goods.

As for railroads, the courts have laid down three different rules or doctrines:

1. Under the Massachusetts rule the transit has been held to end when the goods have arrived at their destination and have been stored by the carrier.
2. Under the New Hampshire rule, when, after the arrival and storage of the goods a reasonable time has elapsed within which the consignee could have received the goods.
3. Under the Michigan rule, only when, after the arrival of the goods, notice has been given to the consignee and a reasonable time for their removal has elapsed after such notice.

Refusal to Accept by Consignee

The duty of the consignee to receive the goods is as clear as the carrier's duty to deliver. The strict liability of the

common carrier cannot be prolonged at the option of the consignee, and the consignee must act with reasonable promptness in taking delivery of the goods. If he fails to do so the carrier's liability as an insurer is thereby terminated.

Delivery to a Connecting Carrier

The law is neither well established nor uniform as to the liability of the common carrier of goods when the complete transit from shipping point to destination is over the lines of connecting carriers. However, if any general rule may be laid down, it is that: Where the goods are received by a carrier to be transported over connecting lines, the initial carrier is not liable for loss or injury occurring beyond its own lines, unless by special contract an obligation is assumed to convey the goods to their destination. The question is further complicated by statutes, both state and federal, most of which, like the Federal Interstate Commerce Act, render the initial carrier liable for loss or damage occurring on the lines of the connecting carrier.

As to whether or not the carrier intended to limit his liability to the carrier's own line, is often a question concerning which the following circumstances have been held to constitute evidence, though not conclusive, from which a contract for through transportation may be inferred: the use of the words "to be forwarded" in the carrier's receipt; issuing of a bill of lading or receipt which purports to be a through contract; the giving of a through rate; prepayment of freight for the whole transportation; the carrier's holding out to carry over the whole distance; or an agreement that the goods be carried through to ultimate destination in a particular car.

When the goods are received by a carrier to be transported to a point beyond its own line, under circumstances which make the initial carrier liable as an insurer only to the end of its own line, there devolves upon him the additional duty to deliver the goods safely to the connecting carrier.

Liability for Goods Lost or Damaged in Transit

When goods are lost or damaged in transit over connecting lines, the consignor has ordinarily no means of showing on the line of which carrier the loss or damage occurred, and as an aid and protection to shippers in presenting their claims under such circumstances, the law has created certain presumptions in his favor.

In the case of damage to, or a partial loss of goods, the presumption is that the loss or damage is attributable to that carrier in whose possession the goods are found in a damaged condition, or with part of the goods missing, which simply means that the presumption is as a rule invoked against the last carrier. This doctrine is based on the theory that once a proper and complete delivery has been made to the initial carrier by the shipper, such a state of facts continues to exist until the contrary is shown to be true. In other words, it is a mere presumption which has the effect of shifting the burden of proof from the shipper to the last carrier.

The same rule has been held to apply also when there has been a total loss of the goods, although it would seem to be unjust to hold such carrier liable in the absence of proof that the goods ever came within his possession. In the case of a total loss it would seem more reasonable at least, as Professor Dobie, of the University of Virginia points out, in fixing the liability, to start with the liability of the initial carrier and work forward through the intermediate carriers, than to start with the last carrier and work backward.

Excuses for Non-Delivery

The common carrier is excused for failure to deliver the goods to the consignee under the following three circumstances:

1. When the goods are demanded by one having a paramount title to them.

2. When the shipper, owing to the insolvency of the buyer, has exercised the right of stoppage in transit, or the goods have been taken by some judicial process.
3. Where the goods, in the absence of negligence, have been lost, owing to one of the previously mentioned excepted perils.

The carrier is estopped, by virtue of the bailment, from denying the title of the shipper at the time of delivery and acceptance of the goods for shipment, and the carrier must deliver the goods, unless legally excused, at the termination of the transit, according to the shipper's instructions. Consequently, if notice of an adverse claim to the goods is served upon the carrier by a third party, the validity of this claim must be determined by the carrier on his own responsibility. He cannot disregard the claim, and if he does deliver the goods to the designated consignee the carrier is liable to the adverse claimant, if his claim proves to be a just one. Again, if the carrier delivers the goods to the adverse claimant he thereby becomes liable to the shipper should such claim later prove invalid.

When, however, the claim made by the third party is well founded the carrier is not only justified in making delivery to such claimant, but is bound to make such delivery, and consequently excused from making delivery to the consignee designated by the shipper. Thus the carrier, when sued by the consignee for non-delivery, has a perfect defense in having delivered the goods to one having a paramount title to them, but it has been held that in order to justify delivery to the true owner, contrary to or without the shipper's orders, the carrier has the burden of proving the ownership and immediate right of possession in the person to whom such delivery is made.

The question as to the right of the shipper to stop goods in transit, based upon the insolvency of the consignee, has been discussed in a preceding chapter. (See Chapter XXV.)

Liability for Carrier's Compensation

A common carrier is given a lien on goods in his possession; that is, if the owner or consignee fails to pay the transportation charges of the goods, the carrier may retain possession of them until such payment is made.

The consignor is primarily liable for the carrier's compensation inasmuch as it is he who is instrumental in inducing the carrier to accept the goods for transportation. There is a presumption, however, that the consignee is liable for the carrier's charges as the owner of the goods in whose behalf the consignor was acting. In accepting the goods from the carrier, the law ordinarily implies a promise on the part of the consignee to pay the freight charges, and that in surrendering the goods to the consignee the carrier obtains the right to look to such consignee for his compensation. This being a mere presumption of ownership in the consignee, it is rebuttable, and if the consignee is proved not to be the owner of the goods, he is not liable merely because another consigns goods to him, if he does not accept them.

It is usual for the bill of lading covering the shipment to prescribe the mode of payment of the freight charges, and in such cases it matters not whether the consignee be the owner or not, or whether the consignor is also liable for the freight. If, however, the consignee, before the goods are delivered to him, indorses the bill of lading to another, who receives the goods, it is held that the carrier must look to such assignee (and not to the consignee) for payment of his charges, unless such assignee is acting in the capacity of an agent for the consignee.

Demurrage and Storage

In the case of a carrier by rail, when the duty of unloading the goods from the car in which they have been shipped rests upon the consignee, the railroad is entitled to recover demurrage when the consignee detains the car for an unreasonable

time, owing to his failure to unload the car with reasonable despatch, even in the absence of an express contract. Furthermore, if the consignee does not accept delivery of the goods within a reasonable time, the carrier may either turn the goods over to a warehouseman, or the carrier may itself store the goods. In such a case, either the warehouseman or the carrier is entitled to collect reasonable storage charges for such service.

Discrimination in Rates

Under the common law, discrimination in rates by the common carrier of goods, in the sense of giving a lower rate to one shipper than to another, was not prohibited, provided both rates were reasonable, and provided the discrimination was not for an illegal purpose. The present-day tendency, however, is to prohibit such discrimination by insisting upon an equality of rates as well as reasonableness, and both state and federal statutes have been enacted prohibiting any discrimination in rates as illegal, because of the absolute dependence of the public on the modern carrier.

The Carrier's Lien

Since the common carrier of goods is compelled to serve all who apply, he is given adequate methods of insuring the payment of his charges, inasmuch as he: (1) may demand payment in advance, and (2) has also a lien on the goods carried to secure the payment of his compensation.

Like other liens, the lien of a carrier is a personal privilege and cannot be assigned. The lien is not lost, however, by the carrier turning the goods over to a warehouseman to be stored until the carrying charges are paid, for in such cases the warehouseman is merely the agent of the carrier, and his possession is treated as the possession of the carrier. The carrier's lien is a special lien, meaning it attaches only to the specific goods carried. Nor can the carrier hold the goods to enforce the payment of a general balance arising out of a series of simi-

lar shipments, or for debts on other consignments previously incurred by the shipper.

A carrier, however, has no lien on goods delivered for transportation by one who is a wrongdoer, and who has no authority to deliver the goods to the carrier. This, of course, works a great hardship on the carrier, since he is bound to receive and carry goods tendered to him for transportation; but, on the other hand, it is his privilege, as we have seen, always to insist upon payment for the carriage of the goods in advance.

Sale under the Lien

At common law the carrier was given no right to sell the goods held under such a lien, but merely the right to hold the goods until the carrying charge was paid, or resort to suit and sale under execution proceedings. Statutes have been passed in nearly all the states, however, empowering the carrier to sell the goods held under the lien for his charges after he has held them a reasonable time, without the necessity of resorting to suit.

Rights of Action against Carriers of Goods

The responsibility imposed by law upon the common carrier of goods is readily apparent from the various rights of action to which he is subject for a failure properly to perform his duties as such. The following rules have been laid down as governing the rights of action which may be maintained against the carrier for the loss of, injury to, or delay in transporting the goods:

1. Where the contract for transportation is directly with the consignor, the consignor, whether or not he retains any interest in the goods, may maintain an action on the contract for any breach thereof; but the recovery is for the benefit of the consignee if the latter is the real owner of the goods.

2. It is to be presumed that the consignee is the owner of the goods and is therefore the person with whom, through the

agency of the consignor, the contract is made. Hence, the consignee can sue on the contract for any breach thereof resulting in the loss of, or damage to, the goods. But the presumption may be rebutted.

3. The person at whose risk the goods are carried, that is, the person having a general or special property in the goods, and who will therefore suffer if the goods are lost or injured, may maintain an action in tort for such loss or injury.

When the contract of shipment is made with the consignor, the consignee, having no interest in the goods, incurs no risk in the transportation, and cannot therefore maintain an action against the carrier. He cannot sue on the contract, for the contract is not made in his behalf. Neither can he sue in tort, for the carrier's duty is not owed to him and he suffers no injury when there is a breach of the duty. The consignee under these circumstances is barred from maintaining any action against the carrier.

Measure of Damages

Certain well-established general rules have been laid down as governing the measure of damages to be recovered in action against the common carrier of goods for—

1. His refusal to accept and transport the goods.
2. Actions for the loss of, or injury to the goods.
3. Actions for delay in transporting the goods.

The principle underlying these general rules is that in determining the amount of damages to which the plaintiff is entitled in an action for breach of duty by the carrier, the law seeks to put the plaintiff in the position in which he would have been had the carrier fully performed his duty. Punitive damages are rarely given.

1. The ordinary measure of damages in an action against the carrier for his wrongful refusal to accept and transport the goods, is the difference between what would have been the

value of the goods at the place where and the time when they should have been delivered, and their value at the time and place of refusal, less the transportation charges.

2. The measure of damages for the total loss or non-delivery of the goods is the value of the goods at the time when and at the place where they should have been delivered, less any unpaid transportation charges. The measure of damages for injury to the goods in transit is the difference between the value of the goods at the time and place of delivery in their damaged condition, and what their value would have been had they been duly delivered in good order, less any unpaid transportation charges.

3. The measure of damages for the delay or non-delivery of the goods is the difference between the value of the goods at the time when and the place where they should have been delivered and their value at the time and place of actual delivery, less any unpaid transportation charges. When, however, the value of the goods is not diminished by the delay, the measure of damages, after unpaid transportation charges are deducted, is the value of the use of the goods during the period of delay.

Special damages arising from the carrier's default are ordinarily not allowed unless the peculiar circumstances out of which these damages arise are communicated to, or known by, the carrier, and unless these damages are also the natural and probable consequence of the carrier's breach of duty.[1]

The Interstate Commerce Commission

Article I, section 8, of the United States Constitution gives Congress the power to regulate commerce, by providing that:

> Congress shall have power to regulate commerce with foreign nations and among the several states and with the Indian tribes . . . . and to make all laws which shall be necessary and proper for carrying into execution the foregoing powers.

[1] Consult Dobies' "Bailments and Carriers" for a more detailed and complete treatment of the subject.

The United States Congress enacted the original Interstate Commerce Act, entitled "An Act to Regulate Commerce," on February 4, 1887, which has now been on the statute books for 35 years, although the scope of the original act has been greatly extended by the numerous amendments since made. The act provides for the creation of an Interstate Commerce Commission to consist of seven members, each of whom is to receive a salary of $10,000 a year.

The act makes it compulsory for all common carriers engaged in interstate or foreign commerce to publish a schedule of their charges for carrying goods or property and if the Commission finds that a rate is unreasonable, it is empowered to prescribe a reasonable one. Carriers who deviate from this schedule, or who give rebates or discriminate between shippers in any way are subject to being fined and the responsible officers and agents are subject to imprisonment. The Commission is further empowered to investigate the profits of the carriers and to fix the maximum and minimum rates for carriage in the proper proportion thereto.

Under this act it is the privilege of shippers who are in any way discriminated against to file a formal complaint with the Commission, and the Commission may then conduct an investigation of the facts set forth in the complaint in much the same capacity as a court of law, and award damages to the injured party. If the carrier then refuses to comply with the decision of the Commission, the latter may invoke the machinery of the United States courts to enforce its order. When this is done, the finding of the Commission is held to constitute a prima facie case.

Section 20 of the act expressly prohibits carriers engaged in interstate commerce from relieving themselves from liability by special provisions incorporated in their bills of lading which previously had become quite common and the effect of which was to evade their common law liability as common carriers.

> Any common carrier, railroad or transportation company receiving goods for transportation from a point in one state to a point in another, shall issue a receipt or bill of lading therefor, and shall be liable to the lawful holder thereof for any loss, damage or injury to such property caused by it, or by any common carrier, railroad or transportation company to which such property shall be delivered, or over whose lines such property may pass: and no contract, receipt, rule or regulation shall exempt such common carrier, railroad or transportation company from the liability hereby imposed: provided that nothing in this section shall deprive any holder of such receipt or bill of lading of any remedy or right of action which he has under existing law.

Proceedings before the Commission

Under the act creating it the Commission is vested with the power of hearing evidence and determining what are reasonable practices and rates of transportation. But how does the complaining shipper proceed to call the attention of this tribunal to his particular grievance and invoke the operation of this governmental force?

In the first place the Commission is not a court, but functions as an arm of Congress and therefore belongs to the legislative branch of government. This is but natural since it is to Congress that the Constitution grants the power to regulate commerce between the states.

Presentation

The act itself sets forth very simple rules of pleading and evidence. It provides that any person, firm, or corporation may file a petition briefly stating the facts complained of. The Commission is then required to send a copy thereof to the carrier who must file an answer in writing. The policy of the Commission has always been that the practice before it shall be as simple and devoid of technicalities as possible.

The Commission is then empowered to investigate the matter and is required to give all parties in interest a full public hearing. The procedure involved in the consideration of

each case is characterized in the formal wording of the order, as follows:

> This case being at issue, upon complaint and answers on file, and having been duly heard and submitted by the parties, and full investigation of the matters and things involved having been had, and the Commission having made a full report containing its findings of fact and conclusions thereon, it is ordered that . . . .

Hearing

The case is heard either by a commissioner in person or by an "examiner." Owing to the increased scope and pressure of business before the Commission, comparatively few cases are heard before the commissioners, although when it was first organized such was the usual practice. However, if the case is one of importance, the parties, upon application to the Commission by letter, may obtain an opportunity to argue the case orally before the entire Commission in Washington.

As a rule, the decisions of the Commission are rendered and published within six months from the date of filing the complaint, and the law requires the Commission to serve a copy of its opinion and order upon the parties in the case.[2]

Uniform Bills of Lading Acts

The effect of the measures provided for in the act creating the Interstate Commerce Commission was to break up state regulation of a growing commerce, which was in fact interstate or national. No provision was made at the time, however, for the standardization of bills of lading to be used by the carriers in handling such interstate commerce, thus leaving to each state the right to exercise its independent judgment as to this aspect of the law of carriers, through its courts and legislative body.

In other words, the states still preserved authority to

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[2] See "Lectures on Procedure before the Interstate Commerce Commission," by C. R. Hillyer.

determine the nature of the bills of lading to be used within their respective territories. In order, therefore, to offset the many disadvantages accruing from a wide diversity of terms and stipulations contained therein, the Uniform Bills of Lading Act was drafted by the Commission on Uniform State Laws in 1909 and submitted to the various states for adoption. It has since been adopted by the following states:

- Alaska, 1913
- California, 1919
- Connecticut, 1911
- Idaho, 1915
- Illinois, 1911
- Iowa, 1911
- Louisiana, 1912
- Maine, 1917
- Maryland, 1910
- Massachusetts, 1910
- Michigan, 1911
- Minnesota, 1917
- Missouri, 1917
- New Hampshire, 1917
- New Jersey, 1913
- New York, 1911
- North Carolina, 1919
- Ohio, 1911
- Pennsylvania, 1911
- Rhode Island, 1914
- Vermont, 1915
- Washington, 1915
- Wisconsin, 1917

The principal advantage accruing from the adoption of such a standard form is that shippers in the states which have adopted this act need not scan each form to ascertain whether it contains any new terms, requirements, or responsibilities.

In 1916 an act [3] was passed by the federal legislature (substantially the same in terminology as the Uniform Bills of Lading Act) providing for the use of a standard or uniform bill of lading in the transportation of interstate commerce. As a result of this act, the same statutory rules and regulations now governing bills of lading in the states above mentioned likewise apply to the transportation of all interstate commerce, which is defined under the federal act as the transportation of merchandise "from a place in one state to a place in another state; or from a place in a state to a place in a foreign country; or, from a place in one state to a place in the same state through another state, or foreign country."

[3] 39 Stat. L. 538.

PART VI

CREDIT AS A MEDIUM OF EXCHANGE

CHAPTER XXXII

ASSIGNMENT OF BOOK ACCOUNTS

Credit Instrument Defined

The world's gold supply is insufficient to meet the current demands of trade, even if used for no other purpose, and today all but a small portion of the world's business is transacted by means of credit in some form or other serving as the medium of exchange. In other words, the economic necessities which have created the various kinds and forms of instruments of credit that are to be discussed in this chapter are nothing more than the ordinary requirements and practices which modern business has made indispensable So, the function of credit in commerce is to act as a substitute for capital. The amount of actual money in circulation in the United States is approximately $4,500,000,000 or about $40 per capita, so it is obvious what the limitation on our commerce would amount to if all transactions were confined to a cash basis.

The term "credit instrument" as used in the commercial world, may be defined as the evidence of an obligation to pay money or to deliver goods. The extent to which a credit instrument may serve as a substitute for money depends upon two things: (1) the nature of the obligation embodied in the instrument; and (2) the form of the instrument—whether it is negotiable or non-negotiable.

Forms of Credit Instruments

There are three forms of credit instruments, as follows:

1. The nature of the obligation may be such that the instrument in which it is embodied is universally accepted in

the country of issue as a substitute for money, and therefore constitutes what is termed credit of "general" or "unlimited" acceptability, e.g., federal reserve notes, bank notes, and silver certificates.

2. The nature of the obligation embodied in the instrument may be such as to limit its use as a medium of exchange to a restricted field. Such instruments constitute what is termed credit of "limited" acceptability, e.g., promissory notes, checks, drafts, bills of exchange, trade acceptances, bills of lading, warehouse receipts, and letters of credit.

3. The nature of the obligation may be such that instead of being embodied in, or evidenced by, some credit instrument which may be conveniently transferred from hand to hand, it is evidenced merely by a "credit" upon the books, or a book account, e.g., book accounts used by the seller of merchandise when he sells goods to a customer.

Book Accounts

Consideration will be given in this chapter to book accounts, which constitute probably the earliest as well as the most simple form of commercial credit. Nowadays, in most all instances when merchants buy from each other, the only evidences of the sale expressed are the entry of the charge in the ledger of the seller and the invoice for the amount of the goods sent to the seller, which when paid closes the transaction. The convenience afforded by this character of credit is readily apparent, but at the same time it is also apparent that the book account does not perform the same useful function in the commercial world as the other kinds of credit instruments, of which the seller may avail himself almost immediately and either purchase additional supplies or use it as the basis for obtaining additional credit. Yet the book account is as valuable a credit instrument as any that is used. It may be sold or assigned, and the purchaser or assignee thereof receives the same right of action against the debtor that the original creditor had. In other

words, there are ways in which book credits may be used in lieu of other collateral for the purpose of securing funds.

Methods of Assignment

Non-Notification Plan. A merchant may assign his accounts to a bank or a commission house, and in return be permitted to withdraw a certain percentage of the value of the accounts thus assigned. Under this plan the merchant's creditors are not advised of the assignment of their accounts to the bank, and the merchant is permitted to act somewhat in the capacity of an agent of the bank to collect the accounts in the usual manner and to use the funds thus collected. As soon as the account is collected, however, the merchant must assign other accounts of equal value to the bank in order that the ratio, or margin, originally agreed upon between the total book value of the accounts pledged and the amount of the loan negotiated may be maintained, that is, assuming that the merchant has not promised to apply directly all receipts from such accounts to the reduction of the loan. Failure on the part of the merchant thus to account for such collections might render him criminally liable if done intentionally to defraud the bank. This is commonly known as the "non-notification" plan.

The usual and most simple form of assignment is as follows:

> For Value Received, I (or we) hereby sell, assign, transfer, and set over unto .... all my (our) right, title and interest in and to the within (annexed, or foregoing) accounts.
>
> ....
> (Signature)

Notification Plan. Another method of assigning book accounts consists of a similar assignment of accounts receivable by the merchant to the bank and a notice of the assignment being sent to all debtors whose accounts have been assigned,

together with a request that they remit direct to the bank. In such cases it is also customary to stamp all subsequent invoices with a notice to the effect that the account has been assigned and is payable to the bank specified in the notice. This method is known as the "notification plan." In other words, the assignment may be made openly or secretly.

This second method of raising needed capital by pledging book accounts is not, of course, so favorable to the merchant, inasmuch as the merchant's business reputation suffers somewhat as a result of his customers being informed of the assignment, whereas under the other plan the fact of the assignment is kept from the knowledge of the customers.

Not being considered to be a high class of collateral security, the rate of interest on such loans is generally higher than the prevailing rate on other kinds of collateral security, and, in addition, a bonus is generally charged for the accommodation, the specific terms under which such loans are negotiated varying in accordance with the nature and character of the accounts. Consequently, the handling of this kind of collateral affords a profitable source of revenue to the bank, and many banking houses have established special departments to handle this character of business. Viewed from the standpoint of the merchant, however, the opposite may be said to be true, because present-day competition is too keen to permit the average merchant to pay an exorbitant rate of interest together with a bonus for the use of such additional funds in his business. Such a practice is bound eventually to leave undesirable effects in its wake.

Purposes for Which Accounts Are Assigned

There are times, however, when the practice may be profitably taken advantage of by a merchant. For example, the discount rate on a purchase may exceed the borrowing rate on accounts receivable, thus making it a paying proposition for a merchant to borrow money on his open accounts with which

to discount the purchase. The way to determine whether or not a merchant can save money by assigning his accounts receivable to obtain funds with which to discount his bills is shown in the following two illustrations:

1. Suppose the purchase amounts to $5,000; the terms of payment are 30–1–10; and the borrowing account on open accounts is 15 per cent.

1 per cent discount	$50.00
$4,950 for 20 days at 15 per cent	40.60
Assigning merchant saves	$9.40

This is hardly a paying proposition, considering the time and trouble incidental to negotiating the loan.

2. Suppose, however, the terms of payment were 30–2–10:

2 per cent discount	$100.00
$4,900 for 20 days at 15 per cent	40.20
Assigning merchant saves	$59.80

Here he saves between 6 and 7 times as much as in the former case.

It is also true that most merchants find themselves hard-pressed for ready funds at some time or other, and it is often possible for them to obtain temporary relief by assigning their accounts receivable when the funds necessary to tide them over their period of embarrassment cannot be obtained in any other manner.

Objections to the Assignment of Accounts

Although the ease with which additional funds can be obtained in this manner presents a constant temptation to the small merchant to overtrade, the main objection to the practice is that it affords an opportunity for dishonest merchants to mislead their creditors as to the true status of their financial condition until it is too late for the creditors to protect themselves. It not infrequently happens that the first notice credit

men receive of such an assignment is when the debtor fails and it is found that the good accounts have already been transferred. This situation would be largely avoided and credit men properly protected if such transfers were required by law to be recorded, as in the case of conditional sales agreements and chattel mortgages, in order to make them valid as against creditors.

The National Association of Credit Men has for years been advocating such legislation to provide:

1. For the recording of such transfers in an office of public record.
2. That notice be given to debtors whose accounts have been assigned.
3. And in event these provisions are not complied with, that such secret transfers or assignments shall be void as against creditors.

Under the rulings of the Federal Reserve Board the assignment of an open account does not come within the meaning of the term "negotiable paper" and is not eligible for rediscount by a federal reserve bank.

CHAPTER XXXIII

NEGOTIABLE INSTRUMENTS AND DOCUMENTS OF TITLE

Non-Negotiable and Negotiable Instruments

Having considered the manner in which mercantile credit in its most simple form of the book account may serve as a medium of exchange for obtaining credit, we come now to the consideration of our second class of credit instruments, or the extent to which such indebtedness may serve as a medium of exchange, or substitute for money, when the obligation of the debtor is evidenced by, and embodied in, some written instrument, e.g., a "promissory note" wherein the debtor expressly promises to pay the amount of the debt or account at maturity.

The extent to which such instruments function in the commercial world as a medium of exchange depends primarily upon the nature of the instrument in which the obligation is embodied—whether it manifests an intention on the part of the debtor to bind himself for the amount of the instrument to the creditor alone; or also to whomsoever the creditor may wish to transfer it. In the one case the instrument is said to be non-negotiable, and in the other, negotiable.

As to whether the debtor intended the one or the other is determined by the words used in specifying the payee of the instrument. If it is a mere promise to pay A, the naming of A, and A alone, operates to the exclusion of all others; whereas, if it is a promise to pay "A or order," the additional words "or order" constitute the necessary words of negotiability and manifest an intent on the part of the debtor to obligate himself

not only to A, but also to whomsoever A may wish to transfer the obligation.

Distinction between Assignability and Negotiability

The early conception of a contract relation was that the agreement created a strictly personal obligation which could not be transferred to another; but later the privilege of assigning their rights under the contract was extended the contracting parties by the courts whereby the assignee was permitted to sue in the name of the assignor but whatever defenses could be set up against the assignor (one of the original parties to the contract) could be interposed against the assignee, and in a modified way this is substantially true today as to ordinary contracts.

Hence, it is readily apparent that if written evidences of debt were to play a very important part in the commercial world, holders of such instruments must be saved the time and trouble of investigating their validity and afforded protection in the enforcement of them, which has gradually been accomplished by formulating a special set of rules with a view to facilitating the transfer of a special class of written contracts called "negotiable instruments."

This fundamental distinction may be illustrated as follows:

> 1. Suppose A has a horse in his stable. B steals it and sells it to C. It is still A's horse and he can demand its immediate return from C. Why? Because B never had a good title to the horse to pass on to C.
>
> 2. Suppose A indorses a check in blank, leaves it lying on a table, and B steals it. B is a thief in both instances and no more a rightful owner of the check than he was of the horse. But suppose he tenders it to C in payment for a bill of goods and C, in good faith and not knowing it was stolen, accepts it in payment. A cannot go to C as he did in the first case and say. "That check you cashed was stolen from me and I want my money." Why not? Because the law will protect the holder of a negotiable instrument when under similar circumstances it will refuse protection to holders of non-negotiable instruments

and other kinds of property for the same reason it refused to protect C in the first example.

So, when we speak of an instrument as being negotiable we mean one capable of being transferred from one person to another in such manner as to constitute the one receiving it the true owner thereof with as good, or, as we have seen, an even greater right to enforce the obligation than the one he receives it from.

Origin of Negotiable Instruments

The negotiability of these instruments as a medium of exchange actually originated in the custom of merchants prior to the eighteenth century, when they came to be recognized and enforced by the law courts (1705). By "custom of merchants" is meant a body of usages and rules relating to trade which grew up among merchants and which the law courts have since endeavored to enforce by affording protection to persons accepting them as a circulating medium of exchange—the primary object of negotiability being to give a certain class of contracts the same function which money plays in commercial transactions.

Requisites of Negotiability

How can we determine whether a certain instrument is negotiable or not? To be negotiable it must conform to the following requirements:

1. It must be in writing and signed by the maker or drawer.
2. Must contain an unconditional promise, or order, to pay a sum certain in money.
3. Must be payable on demand or at a fixed or determinable future time.
4. Must be payable "to order" or "to bearer."
5. Instrument must be specific as to all parties concerned.
6. Must be delivered.

1. The first requisite needs no explanation.

2. The reason the promise or order to pay must be unconditional and payable at all events is to facilitate its circulation. If the promise or order was dependent on a certain contingency, the uncertainty as to whether that condition would be fulfilled would tend to restrict its negotiability. Likewise the sum of money to be paid must be definitely specified or capable of being calculated by an almost mechanical computation, such as figuring the interest.

3. Were there any doubt as to when or whether the money will ever be paid, the negotiability of the instrument would be destroyed.

4. The words "to order" or "to bearer" constitute the necessary indicia of intention of the maker that it shall pass freely from hand to hand, and no instrument is negotiable that does not contain the one or the other.

5. The names of the parties to a negotiable instrument must appear on the face of the instrument and must be certain. An instrument whereby A promises to pay, but which is signed "A or B," is not a promissory note. One reading, "I promise to pay $300 on demand for value received," and signed without stating to whom payment is to be made is not a good promissory note.

6. Delivery means transfer of possession with intent to transfer title. In other words, the mere writing and signing of a negotiable instrument creates no obligation or right of action whatever until it is delivered.

Non-Essentials

Particular note should be taken of the fact that the validity and negotiable character of an instrument are not affected by the fact that:

1. It is not dated.
2. It does not specify the consideration given or that any consideration was given.

3. It does not specify the place where it is drawn or place where it is payable.

Promissory notes, drafts, checks, acceptances, bills of lading, and warehouse receipts are real instruments of credit which can be used as a medium of exchange, or substitute for money.

Forms of Negotiable Instruments

A promissory note is an unconditional promise in writing signed by the maker, to pay absolutely and at all events a

$..*25.00*...... ....*September 1*........... 19.*22*.
............*Thirty days*............ after date ......*I*...... promise
to pay to the order of ....*Malcolm Kemper*................
......*Twenty five* (*$25.00*).................................. Dollars
at ....*Louisville, Ky.*....................................
Value received
No. ..——.. Due ..*October 1, '22*.. ....*Herbert C. Schwab*..........

Form 20. Promissory Note

sum certain in money either to the bearer or to a person therein designated or to his order (Form 20). With the exception of the bank check, the promissory note is the most common and perhaps the most widely used mercantile credit instrument. In form it may be made either negotiable or non-negotiable. If it is made payable "to ...., or order," or "to bearer," it is negotiable; whereas if it is made payable to a particular person only, it is non-negotiable.

A draft is an unconditional order in writing by one person to a second person directing the payment to another of a sum of money absolutely and at all events. It must be formally accepted by the party on whom it is drawn before any obligation is created. By "accepted" is meant that the party on whom the draft is drawn must signify his willingness to pay it by writing across the face of it "Accepted," together with date and signature.

A bank draft is a bank's check drawn upon some other bank in which it has funds on deposit or established credit. A commercial draft (Form 21) is an order made by one merchant upon another to pay a certain sum of money. Usually the payee in such instances is the drawer of the draft, although it may be some third party to whom the drawer is indebted. The draft may be made payable "at sight," or ". . . .days after sight." The former is called a "sight" draft, the latter a "time" draft.

NO PROTEST
Please take this off before presenting.
If not paid at maturity, return at once, stating reasons.

$. .*8.00*. . THE WATSON & GROVE CO.
Cincinnati, Ohio, ...*Feb. 29*, 19.*22*. .
. . . . . .*At sight*. . . . . Pay to the order of ourselves
. . . .*Eight*. . . . . Dollars
Value received and charge to account of. .*Inv. 11/22/'22*. . .
To . . . .*Messrs. Bowers & Co*. . The Watson & Grove Co.
. . . .*Chatham, N. J*. . By. . . .*R. B. Smith*. . . . .
Ass't Treas.

Form 21. Commercial Draft

Before being accepted a draft is not a credit instrument because there is no binding obligation embodied in the instrument—only a request by one party addressed to another (the drawee). After acceptance, however, the obligation of the drawee (party upon whom it is drawn) becomes the same as that of the maker of a promissory note.

Cincinnati, O., ...*August 23*. . . .19.*22*. No. . .*196*
MERCHANTS' NATIONAL BANK
Pay to the order of . . . . . .*James S. Bussey*. . . . . . $. .*75.00*. .
. . . . . .*Seventy-five*. . . . . Dollars
. . . . . .*Carl Phares*. . . . .

Form 22. Bank Check

A check (Form 22) is a draft or order on a bank directing the payment on demand of a certain sum of money to a

certain person named therein, his order, or to bearer—purporting to be drawn against funds of the drawer on deposit in the bank. Owing to the convenience it affords, the bank check has become the principal means of making payment for goods sold, and is used almost exclusively in the payment of larger amounts, or debts, in a distant city.

The theory or principal underlying the use of bank checks is that the maker, or drawer, has sufficient funds on deposit with the bank upon which the check is drawn to cover the amount of the check. When, however, the bank refuses to pay the check because the maker has not sufficient funds on deposit, the check becomes a direct promise of the maker who may be liable upon it by the payee.

When either the maker or payee of a check wishes to establish beyond question the fact that there are sufficient funds on deposit, the common practice is to have the check certified by the cashier of the bank upon which it is drawn. It then becomes a certified check. A certified check, then, is one on which the word "Good" or its equivalent, has been stamped or written, together with the date and signature of the cashier or paying teller of the bank thereby certifying that the drawer of the check has sufficient funds on deposit to pay it and making the bank liable to the holder for its payment. When the bank certifies a check it immediately sets aside so much of the maker's funds on deposit to pay it, as a means of self-protection.

Liability of the Maker of a Check after Certification

No one in giving a check, whether certified or not, makes any representation as to the solvency of the bank, and the only case in which the liability of the maker of a certified check can arise is in event of the bank's insolvency.

Upon certification the bank becomes entitled to, and if its business is properly conducted actually does, charge the amount of the check to the account of the drawer, thus in

reality apropriating to the payment of the check the necessary amount of the money on deposit to the credit of the drawer, precisely the same as though the check were paid. In other words, as between the bank and the drawer, certification has the same effect as payment, the funds representing the amount of the check being just as effectively withdrawn from the control of the drawer.

The question whether this change in the rights and relations of the parties should discharge the drawer from further liability on the check is still in an unsettled state, but the weight of opinion is in favor of the conclusion that the drawer under such circumstances is discharged. On principle, certification, instead of creating an additional obligation on the check itself, creates an entirely new instrument, superseding the check altogether, by reason of which the prior parties to the check are wholly discharged.

It being established that when the holder procures the certification of a check the maker thereof is discharged, because the maker has lost all control of his funds to the amount of the check and the holder has obtained a new obligation from the bank to honor the check when presented for payment, the same reason would seem to apply with equal force to the case where the maker himself procures the certification before he delivers the check to the payee. The payee in such a case takes the check solely on the obligation of the bank.

In other words, a certified check is a substituted obligation, whereby the maker is discharged. The holder or payee impliedly says, "Give me the promise of the bank, and I will discharge you," and the maker says to the bank, "Promise the payee and I will discharge you." The check is thereby necessarily extinguished and it becomes a promissory note of the bank, or, as it has been held in numerous cases, a certified check is the same as a certificate of deposit.[1]

[1]See VI Har. Law Rev., 138.

State of Authorities

The law is well settled that if the payee or subsequent holder procures the certification, the maker is discharged. But it has been held in numerous cases arising in different jurisdictions, that where the maker himself procured the certification, he was not discharged. (Illinois, Colorado, New Jersey, Ohio, Louisiana, New York, and Indiana.) The reasoning in these cases is not clear, and it is difficult to see wherein the courts have been justified in drawing their distinction where the payee has procured the certification.

In order consistently to uphold this distinction, it is necessary to maintain that in one instance a certified check is a new instrument, a promise on the part of the bank substituted for the check; and that in the other the old obligation, although an entirely different instrument after the certification, persists with the original liabilities. In other words, "the logical conclusion to be drawn from such a distinction is that the legal effect of a certification is not the same in all cases, whereas it is impossible for the same act to have two different legal consequences."

Opposed to those jurisdictions already referred to is the decision of the United States Supreme Court, reported in 94 U. S. 343, wherein the court stated:

> Whether this certification be obtained by the drawer before the check is delivered, and is thus made an inducement to the payee to receive the same, or whether it is made upon the application of the payee for his security, is of no importance.

Liability of the Bank before Certification

To the Drawer. There is an implied promise on the part of banks to honor all checks and drafts drawn by the depositor when presented for payment, provided there are sufficient funds on deposit. And the law is well settled that in event a check or draft is wrongfully dishonored by the bank, the depositor may maintain an action against the bank for whatever damage

he or his business reputation may have suffered as a result of it.

To the Payee. This promise on the part of the bank, however, creates no privity between the bank and the party in whose favor the check or draft is drawn, and consequently a breach of this obligation does not give rise to a right of action in behalf of such creditor, unless the check has been certified. There are jurisdictions,[2] however, where it has been held that the drawing of a check operates as an assignment of the amount for which it is drawn, thus creating a direct obligation on the part of the bank to the payee, and for the breach of which the payee can hold the bank liable.

Liability of the Bank after Certification

After certification, however, the obligation of the bank to the holder of the check becomes direct and absolute. In a New York case involving this question, the court laid down this general principle:

> By certification the bank enters into an absolute undertaking to pay the check when presented within the Statute of Limitations. The transaction as between the holder of the check and the bank is substantially the same in legal effect as though the holder had received payment and had deposited the money with the bank and received a certificate of deposit therefor.

Post Office Money Order

A post office money order (Form 23[3]) is an order issued by one post office on another directing the payment of the sum specified therein to the person designated, or to his order. The maximum amount for which a single money order may be issued in the United States is $100. The rates range from 3 cents, when the amount is $2.50 or less, to 30 cents for $100. It is a negotiable instrument that is widely used to facilitate the transfer of funds, and it performs a function similar to checks and bank drafts.

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[2] Illinois and Nebraska.
[3] From Kester and Koopman, Fundamentals of Accounting, Vol. I.

When a purchaser of merchandise does not carry a bank account and desires to send money in payment of a purchase to someone at a distance, a money order for the desired amount may be purchased at any branch post office and made payable

21834 New Rochelle, Sta. 3, N. Y. 31
OFFICE NUMBER SERIAL NUMBER
United States Postal Money Order
AUG 15 1921
DOLLARS 72 CENTS
AMOUNT FOR WHICH ISSUED
THE POSTMASTER AT
Helena, Montana
WILL PAY AMOUNT STATED ABOVE TO ORDER OF PAYEE NAMED IN ATTACHED COUPON OF SAME NUMBER. IF ISSUED WITHIN THE CONTINENTAL UNITED STATES, ALASKA EXCEPTED, THE POSTMASTER AT ANY MONEY ORDER OFFICE IN THE CONTINENTAL UNITED STATES, ALASKA EXCEPTED, WILL PAY IF PRESENTED WITHIN THIRTY DAYS FROM DATE OF ISSUE
PAYING OFFICE
Richard Roe
POSTMASTER
RECEIVED PAYMENT
STAMP HERE
SPECIMEN

PAYING POSTMASTER DETACH COUPON ON THIS LINE

New Rochelle, Sta. 3, N. Y. 31
21834
OFFICE NUMBER SERIAL NUMBER
Coupon for Paying Office
NOT TO BE DETACHED BY HOLDER
Sixty-six DOLLARS 72 CENTS
PAYEE. WRITE WORDS FOR DOLLARS. FIGURES FOR CENTS
Mr. R. M. Rickard
Helena, Montana
REMITTER.
John Doe
THIS MONEY ORDER IS NOT GOOD FOR MORE THAN LARGEST AMOUNT INDICATED ON LEFT-HAND MARGIN OF THE ORDER AND ANY ALTERATION OR ERASURE RENDERS IT VOID
ISSUING OFFICE
STAMP HERE
SPECIMEN

Form 23. Post Office Money Order.

to the seller, who upon receipt of it presents it at his post office and receives payment.

Stipulation Providing for Payment of Collection Costs and Attorney's Fees Does Not Affect Negotiability of Instrument

Article 11, section 20 of the Negotiable Instruments Law provides that:

> The sum payable is a sum certain within the meaning of this Act, although it is to be paid with costs of collection, or an attorney's fee, in case payment shall not be made at maturity.

Validity of Provision

There is not a sufficient uniformity among the decisions on this question to establish any general rule of law, but the weight of authority seems to favor the validity of such provision. The decisions on the point may be classified as follows:[4]

[4] See Credit Men's Manual of Commercial Laws, p. 207.

1. Where the instrument specifies no definite amount.

(a) States holding stipulation valid:

Alabama	Missouri
Arizona	Montana
Dakota	Oklahoma
Florida	Oregon
Idaho	Pennsylvania
Illinois	South Carolina
Indiana	Tennessee
Iowa	Texas
Louisiana	Utah
Maryland	Virginia
Minnesota	Washington
Mississippi	Wisconsin

(b) States holding stipulation invalid:

Arkansas	Nebraska
District of Columbia	North Carolina
Kansas	Ohio
Kentucky	

2. Where the instrument specifies a definite amount.

(a) States holding stipulation valid:

Alabama	Mississippi
California	Missouri
Colorado	New Mexico
Dakota	Oklahoma
Florida	South Carolina
Idaho	Tennessee
Illinois	Texas
Indiana	Washington
Louisiana	Wisconsin
Minnesota	

(b) States holding stipulation invalid:

Arkansas	Michigan
District of Columbia	North Carolina
Kentucky	West Virginia

What Law Governs Validity and Enforcement of Provision

The validity of the provision with regard to costs of collection is a question of substantive law, and is therefore determined in accordance with the laws of the state in which the obligation was entered into. Such being the case, if the provision is valid in the state in which the obligation was made, it will be recognized as valid in other states, unless it is denied such recognition on the ground that such an agreement is contrary to public policy.

The enforcement of such a provision is a question of remedy, and therefore determined in accordance with the law of the state in which it is sought to enforce the obligation. Such being the case, if the provision is valid in the state in which the obligation was entered into but invalid in the state in which suit is brought, such fees are not recoverable.

Documents of Title

Warehouse receipts and bills of lading are not, strictly speaking, negotiable instruments, as neither provides for the payment of money, but rather negotiable documents of title to goods, susceptible to transfer under quite similar regulations whereby title to the goods designated in the instrument is transferred.

Sales by Transfer of Document of Title

When goods are shipped, a document is issued by the carrier which partakes of a twofold nature: (1) it acknowledges receipt of the goods described therein, and (2) promises to deliver the goods to the proper party and at the place specified therein. This document is called a "bill of lading."

When goods are stored in a public warehouse, a similar document: (1) acknowledging receipt of the goods, and (2) agreeing to deliver them to the proper party on demand or at some specified future time, is executed by the warehouse company. This document is called a "warehouse receipt."

Documents of this kind are called "documents of title." They represent the goods, and a sale or pledge of the goods can be accomplished by a transfer of the document representing the goods.

Negotiable and Non-Negotiable Documents of Title

Bills of lading and warehouse receipts may be issued in either negotiable or non-negotiable form, depending on whether delivery is to be made to "the consignee only" or to "the consignee or his order." A non-negotiable bill of lading is called a "straight" bill of lading, and a negotiable bill is called an "order" bill. The former directs the carrier to deliver the goods to some particular person specified in the bill of lading and to none other; whereas a negotiable bill of lading directs the carrier to deliver the goods to some particular person specified in the bill of lading "or order," meaning, or according to the order or subsequent directions of the consignee.

How Transfer Is Effected

The transfer of a document of title is effected by a delivery of the document, properly indorsed when necessary. Negotiable documents of title are made deliverable either "to the order" of a certain person, or "to bearer." If the former, the person so specified must indorse the bill; if it provides for delivery "to bearer," such an indorsement is not necessary and transfer may be accomplished by mere delivery of the document. A non-negotiable document of title can also be transferred by assignment.

Effect of Transfer

Both kinds of documents are transferable to effect a sale or transfer of the goods, but there is an important distinction made in determining the legal rights resulting from such transfer.

In the first place, the carrier need not assume that a straight

bill of lading has been transferred until he has been notified of the transfer, and he may, therefore, deal with the original consignee specified in the bill of lading without his production of the bill of lading; whereas in the case of a negotiable bill of lading it must be assumed that the bill of lading may have been transferred and therefore its production must be required by the carrier before the goods are delivered.

Secondly, while both kinds of documents are transferable, the transfer of a non-negotiable bill of lading has only the effect of a legal assignment of the rights of the transferer, or consignee specified in the bill; whereas the transfer of a negotiable bill of lading entitles the transferee to all the rights and remedies of an innocent purchaser for value of a negotiable instrument under the Negotiable Instruments Law.

The importance and practical effect of this distinction can best be illustrated by supposing the following examples:

1. A ships goods to B and the bill of lading (straight) directs delivery to consignee B.

2. A ships goods to B and the bill of lading (negotiable) directs delivery to consignee B "or order."

The bill of lading in each instance is sent to B, who in both instances indorses it to C, an innocent purchaser of the goods for value. The following day B becomes insolvent, and upon receipt of this information A immediately exercises his right of stoppage in transitu and instructs the carrier to hold the goods.

In (1), the document being straight, or non-negotiable, C by transfer of the document could get no better title or greater right to the goods than B. In other words, whatever rights A has against B with regard to refusing to deliver the goods, he likewise has against C, and as B cannot demand delivery of the goods from the carrier because of his insolvency, neither can C.

In (2), however, the document was drawn "to B or order," showing that it was intended to give B the privilege of transferring the title to the goods by transfer of the bill of lading,

and inasmuch as B was solvent at the time he indorsed the bill of lading to C, C thereby got a good and independent title to the goods and is in a position to demand delivery from the carrier, as he now has a greater right to the goods than B through whom he derived title. A is left to get what he can by sharing with the other general creditors in the insolvent estate of B.

Furthermore, the result would be the same from a legal point of view where a negotiable bill of lading is transferred to a bona fide purchaser for value after the transferring has become insolvent. The principle underlying this rule of law is that where a loss must be suffered by one of two innocent parties, it should fall on the one who made the loss possible, which in such a case would be the creditor who sold the goods on credit and made it possible for the purchaser to transfer title to the goods by transfer of the negotiable bill of lading.

It is also well to remember that neither a carrier nor a warehouseman warrants that title to the goods is in the depositor (the goods may consist of stolen property), but merely that the goods specified in the document have been received from the consignor, and they are therefore under obligation to surrender the goods to the rightful owner in event the property was stolen—otherwise they would render themselves liable for "conversion" of another's property.

CHAPTER XXXIV

NEGOTIATION

Methods of Negotiation

Negotiation, or transfer, may be: (1) by indorsement and delivery, or (2) by delivery alone, according to the nature of the instrument and whether it does or does not require an indorsement.

An instrument is negotiated when it is transferred from one person to another in such manner as to constitute the transferee the holder thereof. If the instrument is payable "to bearer," or if the last indorsement is in blank, it may be negotiated by delivery, the same as money. If payable "to order," it is negotiated by the indorsement of the holder on the back of the instrument followed by delivery.

Indorsement consists in writing the name of the indorser on the instrument with the intent either to transfer title to same, or to strengthen the security of the holder by assuming a contingent liability for its future payment.[1] It is primarily a contract whereby the indorser promises to pay according to the tenor of the instrument in event it is dishonored by the maker or acceptor when presented for payment, provided he is properly notified. An indorser incidentally warrants:

1. That the instrument is genuine (free from forgery).
2. That he has a good title to it to transfer.
3. The contractual capacity of the parties to it.
4. That he has no knowledge of any fact which would impair its validity.

[1] Norton, Bills and Notes.

Kinds of Indorsement

Indorsements may be either special or in blank, and may be qualified or unqualified.

A special indorsement specifies the person to whom, or to whose order, the instrument is payable, and the indorsement of such indorsee is necessary to the further negotiation of the instrument.

EXAMPLE: Pay to A B or order.

This could not be transferred or negotiated without the indorsement of A B.

A blank indorsement specifies no indorsee. The indorser simply writes his name on the back of the instrument, and it thereupon becomes payable to bearer and may be negotiated or transferred by delivery. The holder may convert a blank indorsement into a special indorsement by writing over the signature of the indorser in blank any contract consistent with the character of the indorsement.

Such unqualified or unrestricted indorsements place no restriction upon the further negotiation of the instrument.

A qualified indorsement simply passes title to the instrument without rendering the indorser liable upon the paper. Such an indorsement constitutes the indorser a mere assignor, and the holder a mere assignee of the title to the instrument.

It may be made by writing above the indorser's name the words: "Without recourse," or other words of similar import. Such an indorsement does not impair the further negotiability of the instrument; it simply exempts the indorser from liability upon it.

EXAMPLE: Without recourse
Malcolm Kemper & Co.

A restrictive indorsement is one which makes the indorsee the agent of the indorser for some particular purpose, usually for collection or for deposit. A restrictive indorsement confers upon the indorsee the right:

1. To receive payment of the instrument.
2. To bring any action thereon that the indorser could bring.
3. To transfer his rights as such indorsee where the form of the indorsement authorizes him to do so.

But all subsequent indorsees acquire only the title of the first indorsee under the restrictive indorsement. Such an indorsement also serves as notice that the holder does not own the paper, and therefore practically prohibits further negotiation except for collection purposes.

EXAMPLE: Pay to A B for collection
Malcolm Kemper & Co.

Liability of Indorser

The legal liability of the indorser of a negotiable instrument is of a twofold nature: (1) he undertakes to pay the instrument if it is dishonored by the payee at maturity, and due notice thereof given the indorser (a qualified indorser, however, does not assume any such obligation to pay); and (2) he warrants:

(a) That the instrument is genuine and in all respects what it purports to be.
(b) That he has a good title to it.
(c) That all prior parties had legal capacity to enter into such a contract.
(d) That he has no knowledge of any fact which would impair the validity of the instrument or render it valueless.

When a person places his indorsement on an instrument negotiable by delivery, he thereby incurs all the liabilities of an indorser.

Rights of Holder

The last transferee or indorsee is the holder. He may be a "holder in due course," or "not a holder in due course," and

his legal rights under the instrument are largely determined by his position in this respect.

Meaning of Phrase "Holder in Due Course." A holder in due course has been defined as one who takes completed and regular paper before maturity, in good faith, for value, and without notice of any defects or defenses. Such a holder is often called a "bona fide holder for value without notice," but the phrase "holder in due course" is the one that is used in the Negotiable Instruments Law to signify an innocent holder for value, or one who has taken the instrument without knowledge of anything unusual in connection with it, and has given a valuable consideration for it.

What Constitutes a Holder in Due Course. In order to be a holder in due course a transferee must have taken the instrument under the following conditions:

1. The instrument must be complete upon its face.
2. He must have become the holder of it before it became overdue, and without notice that it had been previously dishonored, if such were so.
3. The holder must have taken it in good faith and for value.
4. At the time it was negotiated to him he must have had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.
5. A holder who derives title through a holder in due course is himself a holder in due course, even though he does not comply with the above requirements.

Rights of Holder in Due Course. The following rules govern the legal rights of a holder in due course:

1. A holder in due course holds the instrument free from all personal defenses (fraud, duress, illegality, lack of consideration, release of maker, etc.) and may enforce payment for the full amount specified against all parties liable upon it; but he does not hold it free from the absolute defenses (forgery, material alteration, infancy, etc.).

2. Every holder of a negotiable instrument is presumed to be a holder in due course. But when fraud, illegality, or a defective title has been set up as a defense, the burden of proof rests on the holder to prove that he purchased the instrument for value and without notice of any such irregularity.

Effect of Irregular Transfer

If the holder of a negotiable instrument is not a holder in due course, and sues thereon for payment, he may be confronted with all the defenses that may be interposed in a suit between the original parties as to why the instrument should not be paid.

Defenses

This brings up the subject of defenses which may be set up by a party to a negotiable instrument. They are generally classified into two groups: (1) real defenses, and (2) personal defenses, depending on whether the defense is attached to the instrument itself, or has grown out of the agreement of the parties to the instrument.

Real or absolute defenses are those which render the instrument unenforcible because there is no contract to enforce, the instrument being void in its inception, such as forgery, infancy, illegality, lack of mental capacity, and material alteration.

Personal or equitable defenses do not invalidate the instrument but question the rights of the parties growing out of the agreement, such as fraud, duress, want of consideration, release, and illegality (when not made a real defense by statute).

Whether or not payment may be refused on any of these grounds depends on whether or not the holder acquired legal title to it without notice of any defects or irregularities, and for value. If so, all equitable defenses are cut off and do not avail against a "purchaser for value and without notice."

In the case of a check it should be promptly presented for

payment or deposited for collection. If it is not, the drawer may be discharged from liability to the extent of the loss, which may be directly attributed to the delay. A local check should be presented for payment before the close of banking hours on the day following the date of its issue.

Overdue Paper

After maturity, negotiable instruments may be transferred by delivery or indorsement, but in such instances the indorsee takes the same, and only the same, interest that his indorser had; in other words, he takes subject to whatever defenses might have been set up against the indorser.

Presentment

The maker of a note, or acceptor of a draft, is liable without presentment for payment, but if the indorser is to be held there must be due presentment upon the maker for payment, except in the case of demand paper which must be presented within a reasonable time.

Time of Presentment. If the instrument is payable at a fixed time, presentment must be made on the day fixed. If the due day falls on Saturday, the Negotiable Instruments Law provides that the instrument is to be presented the following Monday. If the instrument is payable "on demand," presentment must be made within a reasonable time after its issue.

Presentment must be made at a reasonable hour on a business day, which means within the usual hours of business.

Place of Presentment. Where a particular place of payment is specified in the instrument, presentation must be made at that place. Where no particular place is specified, the place of business, or residence, of the maker is understood or implied.

Mode of Presentment. To constitute a legal presentment the instrument must be exhibited to the person from

whom payment is demanded, and when it is paid, the instrument must be delivered up to the party paying it.

Notice of Dishonor

Necessity of Notice. The second condition on which the indorser assumes liability for payment is that due notice shall be given him that the instrument has been dishonored when presented for payment, and any indorser to whom such notice is not given is discharged as having been deprived of the opportunity to avail himself of whatever rights he may have had for immediate self-protection.

Augusta, Ga., ...*Oct. 15*...... 192—

Sir—

Take Notice, that a ....*note*............................
..............*made*............ by ....*Karl A. Griffith*........
For..........*$700*...
Dated ....*July 27, 192—*....................................
Payable ....*three months*.......... after date, ...
at ....*the Merchants*........ National Bank, of Augusta, and endorsed by you, was this day Protested for non-payment and that the holders look to you for the payment thereof, payment having been demanded and refused.

Yours respectfully,
......*Frank D. Wickham*......
Notary Public

To ...*Oliver C. Edwards*...

Form 24. Notice of Dishonor

Form of Notice. The notice (Form 24) may be written or oral, and it is sufficient if it identifies the instrument and indicates that it has been dishonored for non-payment. It may be delivered personally, or sent by mail. It may be given to the party himself or to some authorized agent.

Time of Notice. Where both parties reside in the same place, personal notice must be given at the place of business of the person entitled to receive notice before the close of business hours on the following day. If given at his residence, it must be given before the usual hours of rest on the following day.

If sent by mail, it must be deposited in the post office in sufficient time for delivery within business hours on the following day.

If the parties reside in different places, the notice should be deposited in the post office in time to go out by mail on the following day.

Where the holder gives notice to the indorser, the indorser has, after receipt of such notice, the same time for giving notice to a prior or antecedent indorser.

Place of Notice. If the indorser has added an address to his signature, notice should be sent there. Otherwise, notice must be sent either to the post office where he is accustomed to receive his mail, or to the post office nearest to his place of residence. If he lives in one place and has his place of business in another, notice may be sent to either place.

If notice of the dishonor of the instrument is received within the prescribed time, it will be sufficient even though not given in accordance with the above requirements. Delay in giving notice is excused when due to circumstances shown to have been beyond the control of the holder.

Protest

Protest consists of a formal declaration by a notary in behalf of the holder that the instrument has been presented for payment, payment refused, and the instrument thereupon dishonored, followed by a formal protest that any loss resulting therefrom shall be borne by the indorsers and not the holder. In event a notary is not available to make such protest, it may be made by any reputable citizen in the presence of two or more witnesses.

The formality of protest is not necessary, except in the case of foreign bills, and the fact of dishonor may be proved by the oral testimony of the party who made the presentment; but as a matter of formality and convenience in proving the dishonor, it is usual and customary to protest all negotiable

instruments. In fact, if it is desired to avoid the expense of protest on instruments payable at a bank, it is necessary to attach notice of "No protest" to the instrument.

The notary also gives the necessary notice of dishonor to the indorsers, but this may be done by the holder or his

CERTIFICATE OF PROTEST

UNITED STATES OF AMERICA } SS.
State of Georgia

BE IT KNOWN, that on the ....*15th*.... day of ....*October*.... in the year of our Lord, One Thousand Nine hundred ....*twenty*——...., at the request of Merchants National Bank of Augusta, Georgia, I, *Frank D. Wickham*, Notary Public duly Commissioned and Sworn, dwelling in the City of Augusta, and State aforesaid, did present the original ....*note*.... of ....*Karl A. Griffith*.... for ....*Seven hundred*.... Dollars, hereunto annexed, at the ....*Merchants Natoinal Bank—Augusta*.... where the same is payable, and demanded ....*payment*.... which was refused.

WHEREUPON, I, the said Notary, at the request of aforesaid, did protest and by these presents do public and solemnly protest, as well against the Maker and Endorser of the said ....*note*.... as against all others whom it doth or may concern, for exchange or re-exchange, and all costs, charges, damages and interest, already incurred, and to be incurred for want of ....*payment*.... of the same.

And I, the said Notary, do hereby certify, that on the same day and year above written, due notices of the foregoing Protest were put into the Post Office at Augusta, postage paid, or served as follows:

Notice....*Robert Blair*..........directed .....*Savannah, Ga*...........
do........*Francis M. Bowles*....do....*9 Kemper St., Elberton, Ga*......
do........*Frank Blaine*.........do......*17 Green St., Augusta, Ga*.....

Each of the above named places being the reputed place of residence of the person to whom the notice was directed.

IN WITNESS WHEREOF, I have hereunto subscribed my name and affixed my Seal of Office.

......*Frank D. Wickham*.........
Notary Public.

{NOTARY'S SEAL}

Form 25. Certificate of Protest

authorized agent. The protest fees which are fixed by statute are added to the amount to be paid by any party liable on the instrument.

Procedure

When the instrument has been dishonored for non-payment, the notary prepares a certificate (Form 25) under his hand and seal setting forth:

1. The time and place of presentment.
2. The manner in which the presentment was made.
3. The request for payment and the refusal given.
4. The cause or reason for protesting the instrument.

This certificate, or a copy of it, is then annexed to the instrument returned to the holder as evidence of the presentment, demand, and dishonor, and a copy sent to each indorser.

Bad Check Legislation

In keeping with the general campaign of the National Association of Credit Men for uniform state legislation pertaining to various legal aspects of credit work, a movement has for some time past been under way to obtain for merchants and creditors adequate protection from the pernicious practice of issuing and negotiating worthless checks—a source of considerable annoyance to a credit man, because the return of every dishonored check necessitates the reopening of the account and requires further time and attention on the part of the collection department to effect a settlement.

To this end laws have been enacted in 45 states (the three exceptions being Delaware, New Hampshire, and New Mexico), making it a crime and providing a penalty for the drawing of checks with intent to defraud without sufficient funds on deposit at the time the check is placed in circulation.

The New York legislature passed such a law in April, 1918. It provides:

> §1292-a. **Obtaining money by fraudulent check, draft or order; how punished.** Any person who, with intent to defraud, shall make or draw or utter or deliver any check, draft or order for the payment of money upon any bank or other depositary,

> knowing at the time of such making, drawing, uttering or delivering that the maker or drawer has not sufficient funds in or credit with such bank or other depositary for the payment of such check, although no express representation is made in reference thereto, shall be guilty of attempted larceny, and if money or property is obtained from another thereby is guilty of larceny and punishable accordingly.
>
> In any prosecution under this section as against the maker or drawer thereof, the making, drawing, uttering or delivering of a check, draft or order, payment of which is refused by the drawee because of lack of funds or credit, shall be prima facie evidence of intent to defraud and of knowledge of insufficient funds in or credit with such bank or other depositary, unless such maker or drawer shall have paid the drawee thereof the amount due thereon, together with interest and protest fees, within ten days after receiving notice that such check, draft or order has not been paid by the drawee.
>
> The word "credit," as used herein, shall be construed to mean an arrangement or understanding with the bank or depositary for the payment of such check, draft or order.

This law, and others of a similar nature, are primarily laws or rules of evidence, the effect of which is to shift the burden of going forward with the evidence from the prosecution to the defendant.

To give a bad check with intent to defraud in exchange for goods has long been a crime, but in order to prosecute successfully such a case it was necessary for the prosecution to prove the intent to defraud, and the knowledge on the part of the drawer of the check that he had not sufficient funds on deposit to cover the amount for which it was drawn. To prove such an intent requires that one prove what was in another's mind at the time the act was committed, which is such a difficult and almost hopeless task that it has been possible to give bad checks with impunity.

Notice of Non-Payment of Check

Under such a "bad," or "no-good" check law, as it is sometimes called, if a check has been returned unpaid, owing

to an insufficiency of funds on deposit to meet it, the holder may give notice to the maker of the non-payment together with the reason therefor, and if the maker does not deposit with the bank within 10 days after receiving such notice the amount due, his failure to do so constitutes prima facie evidence of his intent to defraud, and of knowledge on his part that he did not have sufficient funds on deposit at the bank. This simply means that whereas the burden of proving the commission of the crime still rests upon the prosecution, the burden of going forward with the evidence has shifted over onto the shoulders of the defendant.

This phase of the law has been criticized on the ground that it permits the individual defrauded to condone the crime upon payment of the sum which he has lost. But, as has been pointed out, this criticism is not sound, for the crime exists even though the money be repaid. The effect of payment of the money is only to restore to the maker of the check the common law presumption of innocence, and place on the state the burden of proving the intent to defraud and a knowledge of having insufficient funds on deposit.

While the statute is silent on the question as to what constitutes proper notice, it would not be prudent for a creditor to endeavor to prosecute a case under the statute unless he is able to prove the giving of proper notice. As a matter of precaution in such instances, the notice should be in writing and should be either handed personally to the maker, or if mailed, the letter should be registered and a return receipt requested.

Four General Situations

A question which logically arises is as to whether this law applies only to instances where the check was given within the state, on a local bank, and for goods sold within the state, or likewise applies to cases wherein the debtor resided without the state, and the check was drawn on the bank of another state, or given in payment for goods sold without the state.

In this connection, there are four general situations with which to deal:

1. Where a resident or non-resident delivers a check within the state on a bank located within the state.
2. Where a resident or non-resident delivers a check within the state on a bank located without the state.
3. Where a resident or non-resident delivers a check outside of the state on a bank located within the state.
4. Where a resident or non-resident delivers a check outside of the state on a bank located out of the state.

In the first and second instances the law applies irrespective of where the check was drawn.

In the third and fourth instances the law does not apply unless the check was drawn within the state, in which cases the courts may hold that it does apply.

In other words, under such a statute, the fact that the bank upon which the check was drawn was located in another state would be immaterial in event the check was either drawn or delivered within the state, because not only does the law provide that the delivery of a check within the state with fraudulent intent is a crime, but also that the drawing of a check within the state with like intent is likewise a crime.

Check Given after Sale and Delivery of Merchandise

The question has also been raised as to whether the law applies to a check given in payment for merchandise sold and delivered previous to the giving of the check. Opinion on this point is divided. Those who give a negative opinion contend that as nothing of value was parted with in exchange for the check, no injury has resulted to the person receiving the check, and that, consequently, no crime has been committed. Until the courts pass on this question it must remain a mooted one.[2]

In some states, no such notice of dishonor to the drawer is required. For example, the "no-good" check law of Ohio, enacted in April, 1919, provides:

[2] See bulletin New York Credit Men's Association for December, 1919.

> Any person who, with intent to defraud, shall make or draw or utter or deliver any check, draft or order for the payment of money upon any bank or other depository, who, at the time thereof, has insufficient funds or credit with such bank or depository, shall be guilty of a felony, and upon conviction thereof shall be fined not less than fifty dollars and not more than two hundred dollars, or imprisoned in the Ohio State Penitentiary for not less than one year nor more than three years or both.
>
> As against the maker or drawer thereof, the making, drawing, uttering or delivering of a check, draft or order, payment of which is refused by the drawee, shall be prima facie evidence of intent to defraud, and knowledge of insufficient funds in, or credit with, such bank or other depository. The word "credit" as used herein shall be construed to mean any contract or agreement with the bank or depository for the payment of such check, draft or order, when presented.

Proving Criminal Intent

The same difficulty is experienced in the enforcement of such a law as is encountered in other cases involving the element of fraud, in that before any conviction can be obtained under the statute it is necessary to prove the existence of the necessary criminal intent at the time the act complained of was committed.

In other words, given a case wherein a check was issued by a merchant when there were insufficient funds on deposit in the bank to cover the amount for which it was drawn, the proof of these facts would, by virtue of the statute, constitute prima facie evidence of an intent to defraud, but the incidental presumption that the check was drawn with knowledge of an insufficiency of funds on deposit could be rebutted by a direct denial of any such knowledge by the drawer of the check, under oath.

It is for this reason that the number of convictions under these statutes has been so surprisingly small, and that the statute has failed to afford mercantile creditors the degree of protection from this abuse that was anticipated of it.
protection from this abuse which was anticipated would result from it.

CHAPTER XXXV

THE TRADE ACCEPTANCE

Use Advocated by Federal Reserve Board

It is in anticipation of the time when trade acceptances will play a more important part in commerce than they do today that this subject is taken up at length, for while its use has so far been very limited among the merchants of the United States, the trade acceptance has for many years been in as general use throughout Europe as bills of exchange, and it is a medium of exchange with which every credit man should be familiar.

> The Federal Reserve Board, through an extensive investigation, determined the fact that an enormous charge was being laid on the business of this country by the open account. Billions of dollars were being represented by mere pen-scratches in ledgers, non-available, rigid, frozen assets. Financial facilities were unused, credit and capital alike were being wasted as in no other civilized country. Banks, the reservoirs of the wealth of the nation, were being used not to finance business in its daily course, but as a last resource. The average seller of goods financed his own transactions, calling on the banks only in emergencies. And so the banks were failing to give to American business that service for which they were primarily organized, and through no fault of their own.
>
> Determined to find the means to link together business and banking, making each dependent on the other, each supporting the other, each responsive to the need of the other, the Federal Reserve Board acting under and interpreting the spirit of the Federal Reserve Act, selected that class of paper which truly represents the business transactions of the country, the purchase and sale of goods, as being the medium to establish the intimate relationship necessary.

And then, to make that link as secure as possible, offering the least chance of loss to either party, the Federal Reserve Board laid down certain requirements to distinguish the trade acceptance from any other commercial paper. The first and most important rule is that the acceptance must bear on its face the statement that the obligation arises out of the sale and purchase of goods; the second, that the acceptance be a clear, definite order to pay, free from any qualifying conditions; the third, that the acceptance be accepted in writing across the face of the instrument.

Such an instrument, bearing the names of both a seller and buyer of known credit standing, representing goods intended for resale, and standing for a current transaction is truly the highest form of commercial paper and as such has been granted a preferential rediscount rate by Federal Reserve Banks.[1]

Trade Acceptance Defined

The only difference between a commercial draft and a trade acceptance (Form 26[2]) is that the latter states on the face of it:

TRADE ACCEPTANCE
FORM APPROVED BY THE AMERICAN ACCEPTANCE COUNCIL

No. 872 Akron Ohio (CITY OF DRAWER) NOV 22 1921 (DATE) 192

ON JAN 21 1922 (DATE OF MATURITY) PAY TO THE ORDER OF OURSELVES

Eleven Hundred Thirty-Six & 75/100 — DOLLARS ($1136 75/100)

THE OBLIGATION OF THE ACCEPTOR HEREOF ARISES OUT OF THE PURCHASE OF GOODS FROM THE DRAWER. THE DRAWEE MAY ACCEPT THIS BILL PAYABLE AT ANY BANK, BANKER OR TRUST COMPANY IN THE UNITED STATES WHICH SUCH DRAWEE MAY DESIGNATE.

TO John T. Roswell (NAME OF DRAWEE)
1881 Broadway (STREET ADDRESS)
New York (CITY OF DRAWEE)

ACCEPTED NOV 26 1921 (DATE)
PAYABLE AT Bank of America
LOCATION OF BANK 44 Wall St
John T. Roswell (SIGNATURE OF ACCEPTOR)

BY Acme Tire Co. (SIGNATURE OF DRAWER)
BY H. C. Brewster

Form 26. Trade Acceptance

"The obligation of the acceptor hereof arises out of the purchase of goods from the drawer as per invoice of . . . ."; and upon acceptance it likewise becomes a promise to pay according to the tenor of the instrument. Consequently, the trade acceptance is a negotiable instrument and subject to the provisions of the Negotiable Instruments Law.

[1] Credit Men's Manual of Commercial Laws, p. 29.
[2] From Koopman and Kester, Fundamentals of Accounting, Vol. I.

Its Function

What is the purpose and effect of showing on the face of the instrument the basis of the obligation? The reason for it is to indicate that the obligation is not based on a loan of money or given in settlement of a past-due account. It increases the value of the instrument as a live asset, and in no way reflects on the buyer's credit standing. While the instrument is technically a draft, it is practically no more than a negotiable receipt and a promise to pay for merchandise purchased.

The theory is that the draft would be drawn for the gross amount of the invoice payable in 30, 60, or 90 days, according to the terms of sale, and sent to the buyer with a copy of the invoice. If the buyer intended to pay within the discount period, he would merely destroy the draft. If, on the other hand, he did not intend to take advantage of the cash discount allowed, he would write "Accepted," together with the date and signature across the face of it, and return it to the seller, thereby constituting a trade acceptance. While there is no reason why a trade acceptance cannot be made to run for any length of time, under the rulings of the Federal Reserve Board only such trade acceptances as have a maturity of not more than 90 days from date of presentation at a federal reserve bank are eligible for rediscount.

The Use of the Acceptance

In order to obtain a clear conception as to the manner in which the trade acceptance is used, let us suppose that A in Cincinnati, sells B in Boston, a bill of goods amounting to $3,000, terms 2 per cent in 10 days, 60 days net. Under the open-account system, unless B discounts his bill within 10 days, the full amount of $3,000 will remain open on A's books for 60 days, and while a good asset (assuming the buyer good for the amount), it will be for the next 60 days practically a dead asset in the sense that A will have to wait that long for his

money. Furthermore, it is quite evident that it would not take a large number of such outstanding accounts to tie up a considerable portion of A's capital in accounts receivable, and it is easily conceivable that A may, and probably will, be forced to borrow money from the bank on his receivables, pending maturity of such open accounts. In other words, under such a system, the seller is practically compelled to serve as banker for his customers, and in event his capital proves insufficient for the purpose, it is necessary for him to seek assistance from the banks, frequently by discounting his receivables at an exorbitant rate of discount.

Now let us suppose that attached to the invoice covering the shipment sent B was a trade acceptance drawn for 60 days, to be signed by B and returned, in event he does not intend to take discount. Upon its receipt A is placed in a position to close the trade on his books immediately and to discount the acceptance at his bank at an established rate, without having to wait 60 days for his money.

Advantages and Disadvantages

The principal grounds on which its general adoption is urged are: (1) the advantages derived from the substitution of time drafts for open book accounts, and (2) that of providing better borrowing facilities in negotiating loans from the banks. And it is more as a matter of information than with a view to championing the virtues of the cause, that the more important features involved in its adoption as affecting all three parties concerned (seller, buyer, and bank) are given:

To the Seller

Advantages. That there is a considerable advantage to the seller in its general adoption no one can deny, because:

1. It enables him to close his ledger account on receipt of the acceptance.
2. By admitting the amount to be correct, the buyer is

precluded from setting up any of those petty grievances and controversies to which a seller is subject.

3. It places him in a better position to negotiate loans, for the holder of an acceptance can sell an asset instead of incurring a debt when funds are desired from the bank.
4. When discounting trade acceptances seller will not be obliged to give the banks such a wide margin of safety in quick assets as would be required in the assignment of his open accounts.
5. It will enable him to calculate his monthly income with greater accuracy and certainty.
6. It amounts to a proof of claim in itself, once the signature has been proved.

Disadvantages. On the other hand, its general adoption is not entirely free from objectionable features from the point of view of the seller because:

1. Tendency would be to convert cash discount customers into acceptance buyers and thereby lengthen the time of credit.
2. Fact that buyer will often have to pay for goods before they are received will tend to influence purchasers to trade with the more responsible houses, and consequently crowd out the "little fellow."
3. Before discounting a trade acceptance at his bank the merchant must indorse it. Consequently, the general adoption of the trade acceptance will mean that the merchant will become an indorser for all of his customers and therefore contingently liable to the extent of their purchases.

To the Buyer

Advantages. Some of the advantages that would accrue to the buyer from its general adoption are:

1. By giving a negotiable certificate of his indebtedness to the seller, the buyer shows his good faith, and by meeting his obligation promptly improves his credit.

2. The fact that the buyer will wish to avoid putting out more paper than he can meet at maturity will tend to make him a more careful and conservative buyer, with less likelihood of his overloading with unsalable merchandise.
3. The time buyer will be doing his part to do away with the tremendous advantage now enjoyed by those who discount their bills and thereby be enabled to compete with his competitors on a more nearly equal basis. (This is, of course, based on the assumption that cash discount will eventually be eliminated entirely by the trade acceptance.)
4. It would also tend to make the buyer a better collector, because the fact that he must meet his obligations promptly will require him to insist upon prompt payment from his own customers.

Disadvantages. Perhaps the most objectionable features incidental to its general adoption from the point of view of the buyer are:

1. By accepting, he admits the seller's claim is correct, and is thereby cut off from later setting up any defense or counterclaim in mitigation of payment.
2. Necessitates paying for goods before they are received, a practice which is objectionable to many merchants.

Favored by Banks

While we are of course primarily interested in the relations existing between buyer and seller, still, when we consider the extent to which merchants are dependent upon commercial banks in the operation and development of their business, the banking interests should certainly receive serious consideration. Suffice it to say, however, that a general adoption of the trade acceptance is strongly advocated by the bankers and for reasons readily apparent, for in negotiating commercial loans, they would receive as security:

1. Tangible evidence of the receivable submitted;
2. Double security instead of single-name paper (long regarded undesirable by the banks for rediscount); and finally,
3. We have their assurance that its general adoption would result in placing the banking system of the United States not only on a more scientific, but a safer and more serviceable basis.

Objections and Difficulties to be Overcome

Every deviation of importance that has been made from established custom or usage in the business world has met with a certain amount of opposition as a sort of challenge to its right to survive. The trade acceptance constitutes no exception. It is also true that in all such controversies it is a natural tendency for its exponents to overstate its advantages, and likewise for its opponents to magnify the objectionable features and difficulties to be overcome. In the case of the trade acceptance, some of the objections raised, however, unquestionably present real obstacles which must be overcome before its general adoption can be brought about. Such are the following:

1. Reluctance on part of buyers to issue negotiable paper for something which they have not received.
2. Fear that the paper will fall into the hands of remorseless collectors.
3. Reluctance on the part of large houses to convert their "discounters" into time buyers.
4. Tendency to draw buyers to the big houses of unquestioned responsibility and thereby squeeze out the "little fellow."
5. Large credit limits are often based on bills being discounted. Acceptances will require larger lines and therefore involve greater risks.
6. Hesitancy on part of wholesalers and manufacturers to depart from old system of open book accounts.

PART VII

INSOLVENCY PROCEEDINGS

CHAPTER XXXVI

THE THEORY OF INSOLVENCY LEGISLATION

Need of Insolvency Legislation

The theory or principle of justice underlying all insolvency legislation is that so long as a merchant remains solvent he is doing business on his own money and may do with it as he wills, but the moment he becomes insolvent he ceases to be doing business on his own money—he has spent his own—and is beginning to do business upon his creditor's money. It therefore follows that the remaining assets in the debtor's hands are, in part at least, the property of his creditors for whose benefit he thereafter holds them. This is, without question, the theory upon which the law has sought to protect creditors through restrictions (insolvency legislation) which have been placed upon the commercial liberty of the insolvent debtor.

Good laws on this subject are not only important but necessary for the preservation of pecuniary integrity and security of the economic basis of trading—the extent to which one can depend on the engagements or obligations of another—and whatever legislation tends to reduce the premium placed on a strict observance of the fundamental principles underlying commercial integrity will necessarily have a corresponding effect on the confidence and safety with which business is transacted.

On this subject one writer has said:

> The statistics of bankruptcy prove the fact that a large part of all insolvencies arise from notorious misconduct; the proceedings of the insolvency and bankruptcy courts will prove it. Excessive and unjustifiable overtrading, or most absurd speculation in commodities, merely because the poor speculator "thought

they would go up," but why he thought so, he cannot tell;—in things with which he is altogether unacquainted, wild and absurd investments, these are among the most innocent causes of bankruptcy.

To have been trusted with money or money's worth, and to have lost or spent it, is prima facie evidence of something wrong, and it is not for the creditor to prove, which he cannot do in one case out of ten, that there has been criminality, but for the debtor to rebut the presumption, by laying open the whole state of his affairs and showing either that there has been no misconduct, or that the misconduct has been of an excusable kind. If he fail in this, he ought never to be dismissed without a punishment proportioned to the degree of blame which seems justly imputable to him; which punishment, however, might be shortened or mitigated in proportion as he appeared likely to exert himself in repairing the injury done.

Legal Distinction between Insolvency and Bankruptcy

Commercial insolvency and bankruptcy are not synonymous. A merchant is considered insolvent, from a commercial standpoint, when he is no longer able to pay his debts as they fall due in the ordinary course of business, because of the difficulty and delay incidental to converting his assets into cash. Whereas insolvency is defined in the Federal Bankruptcy Act as follows:

> A person shall be deemed insolvent within the provisions of this act whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, with intent to defraud, hinder or delay his creditors, shall not, at a fair valuation, be sufficient in amount to pay his debts.

It therefore follows that it is entirely possible for an insolvent concern to continue in business indefinitely, if it can manage in some manner (usually borrowed money) to meet its obligations as they fall due, and remain immune from bankruptcy proceedings. In other words, a concern may be insolvent but not bankrupt, whereas to be bankrupt it must

necessarily be insolvent. It is not, therefore, technically correct to apply the term bankrupt to one who is merely insolvent.

It is also interesting to note in this connection that statistics extending over a period of five years show that 60 per cent of the business failures were due either to: (1) incompetence, such as bad management, either in making an unwise selection of stock in buying, inefficient salesmanship, or an inaccurate accounting system; or (2) lack of capital, either insufficient in the beginning, failure to keep a sufficient amount of it in liquid assets, or an injudicious deflection of funds for the payment of interest and dividends.

Means of Relief Afforded an Insolvent Debtor

Once insolvent a debtor can do but one of five things:

1. Effect an adjustment with his creditors.
2. Make an assignment of all his assets, a process whereby his assets are transferred to his creditors.
3. Apply for a receiver.
4. Go into bankruptcy, by filing a statement of his assets and liabilities with the referee in bankruptcy and requesting to be declared a bankrupt.
5. Wait until his creditors force him into bankruptcy by proving he has committed an act of bankruptcy while insolvent.

CHAPTER XXXVII

ADJUSTMENTS

Importance of Full and Correct Information

Bearing in mind that what the insolvent debtor desires is a release or discharge from his debts, a formal release from each and every one of his creditors would be as effective as a decree of the court, in so far as any future liability is concerned.

Such a release may be brought about in any one of several ways, and before a credit man is in a position to make an intelligent decision as to the most advisable course to pursue in protecting his interests, he must obtain all the information he can concerning the business of the debtor. The reason for this is that if full information shows that there is some justifiable explanation or reason for the embarrassed condition of the debtor, and that the nature of the difficulty is of a temporary character, there is no great cause for alarm, and under such circumstances a great mistake would be made and a great injustice done the debtor if drastic measures were immediately resorted to. On the other hand, if such information shows the business to be in a precarious condition and the debtor heavily involved, steps of a more radical nature must be taken properly to safeguard your interests and curtail any further loss. In other words, the line of approach must naturally and necessarily be largely determined by the existing circumstances which are never precisely the same in any two cases. Such an investigation, of course, may be most satisfactorily accomplished by having a personal conference with the debtor at his place of business, and where his business records are available, for once a debtor admits his insolvency, his books are subject to inspec-

tion by the creditors. In event, however, that the credit man is unable to give the matter his personal attention (he seldom is) and the size of the account justifies the incidental expense, there are professional adjusters who make it a business to handle such accounts.

The Amicable Adjustment

To facilitate an orderly discussion of the subject, let us first assume that the information discloses that the debtor has a large equity in his business, that is, an actual surplus of total assets over total liabilities, but that his present condition is such that he is unable to meet his current obligations as they fall due. This condition is generally due to his having an insufficient amount of available working capital, which in turn may have resulted from his overstocking, too liberal extension of credit, carelessness in following up his collections, or any one of numerous other causes, and all that is required is time and patience on the part of his creditors in order to give him an opportunity to work out a readjustment of his finances.

When a debtor is thus situated, it behooves the credit man to act with the utmost care before resorting to any drastic action which would bring about the bankruptcy of an honest debtor. Owing to the degree of risk necessarily involved in all business, such situations are practically inevitable and are oftentimes due to conditions absolutely beyond the control of the debtor. Furthermore, such debtors are at least entitled to the moral support and moral assistance of their creditors, particularly those who over a period of years have profited from their business relations with the debtor.

What an Amicable Adjustment Implies

A personal adjustment implies an amicable or friendly settlement. The adjuster, representing the creditor, comes as a personal representative of the house, armed with authority to settle any points in dispute, to smooth over difficulties, and

above all else to effect some satisfactory adjustment of the account. An expert adjuster, after obtaining the information he desires, often knows more about the business of the debtor than the debtor himself, and advice is all that is frequently needed as a solution of his difficulties. In such instances the attitude of the credit man, confident of ultimately obtaining a full settlement of his account, should be one of watchful waiting and friendly interest in the readjustment of the debtor's affairs. Such a policy has proved itself not only the most profitable in the end, but almost always results in the acquisition of a loyal and grateful customer of the house for the future.

Whenever the mistake responsible for the condition of affairs can be remedied and corrected with expert assistance and the co-operation of creditors, the aim of the adjuster is to save the business, as well as to protect the creditors, and this is frequently accomplished by having the debtor pay a certain percentage of his accounts in cash, and inducing the creditors to accept short-term notes for the balance. In event a series of notes is given, the type known as the "foot-throttle" note, which provides that on default of any one of the series the balance become due immediately, is preferable and should be insisted upon. Otherwise, each note must be sued on separately as it matures.

Extensions

If an extension is deemed advisable, it becomes the duty of the adjuster to seek to represent and act as agent for all or at least a majority of the creditors, because otherwise a settlement to be worked out over an extended period may meet with serious opposition from a few creditors who may retard the consummation of the proposed settlement by neglecting to give their assent. This is particularly true when there are numerous creditors located at a distance from the debtor. Properly handled, however, experience has proved that when such an

extension is recommended by the adjuster, or adjustment bureau, most, if not all, of the creditors will give their consent to the proposed arrangement, realizing that the adjuster is acting impartially and seeking to obtain for them the most advantageous settlement possible.

If an extension is to be arranged, one of several methods may be followed. A trust agreement may be entered into between the debtor and the adjuster in behalf of the creditors. In such a case the bureau usually asks the creditors to assign their claims to it, because once this has been accomplished the debtor has only the one creditor to deal with instead of a large number, and it serves to relieve the constant apprehension of one or two creditors insisting upon a prompt settlement or threatening to take drastic action to protect their interests. The agreement may provide for a continuation of the business by the debtor himself or by a representative of the bureau. In this way the co-operation of creditors is assured, and it then becomes an easy matter to secure co-operation on the part of the debtor also. But should he remain obdurate and compel the adjuster to resort to legal measures, such action is simplified because the creditors are cemented by a common interest and act as an individual through the medium of the adjuster. This is seldom the case, however, and usually the debtor realizes that it is to his best interests to co-operate with the adjuster.

Legal Aspects of Extensions

The question may arise in the minds of either the creditors or debtor as to whether an agreement for an extension of time is binding on the creditors. Every contract or agreement to be binding must be supported by some consideration. So, obviously, an agreement by one creditor to give a debtor an extension of time, without any consideration, is not binding on the creditor. Where, however, several creditors agree among themselves and with the debtor, that in consideration of each creditor's forbearance each of the other creditors will agree to

an extension, there is sufficient consideration to support the promise of each creditor; and no one creditor, at least without the consent of all others, would have the right to demand payment before the extended time had expired.

When the Cause of Insolvency Is of a Permanent Nature

Under certain circumstances it would be unwise for creditors to grant any such extension. This is obviously true when the investigation discloses that the debtor's affairs are badly involved, or where the statement shows an actual deficit to exist. In such cases a real adjustment becomes necessary.

Composition Settlements

Sometimes it is possible for the debtor to arrange for what is called a "composition settlement" with his creditors, whereby he resumes charge and ownership of his business freed from the claims of his creditors. This consists of an agreement between the debtor and his creditors (not necessarily all) whereby each of the creditors, in consideration of each other's promise to do likewise, agrees to release the debtor from his entire debt upon receiving partial payment from the debtor. The confirmation of such a composition is in effect a discharge, or release, resulting from mutual consent and valuable consideration, and not by operation of law, as in the case of bankruptcy compositions.

The composition settlement is usually brought about on the initiative of the debtor, who submits terms of compromise. The proposition may be made to the creditors individually, or at a creditors' meeting called for the express purpose of considering the debtor's proposal. The latter is more conducive to success, for when the creditors are numerous and scattered abroad, a few will generally be found who are not amicably disposed toward the debtor and this always presents an obstacle to the bringing about of such a settlement. Offers of composite settlements should never be considered by creditors when any suspicion of fraud attaches to the insolvency.

When to Agree to a Composition

This form of settlement is to be highly commended, and the creditors should agree to such a settlement, under proper conditions, for two reasons.

First, This form of settlement is due the honest debtor. The creditor is in a way a partner in the debtor's business, and losses must be expected in business. An honest debtor's offer should be encouraged and accepted so that the debtor may regain his business and save himself and family from disaster.

Second. It is to the interest of the creditor to have a settlement made in this form. To illustrate, let us assume that a merchant has a business which shows a relation of 75 per cent assets to liabilities. The business may be worth 75 per cent of the liabilities as a going concern. But in forced liquidation the assets would realize much less than their book value. If the business went through bankruptcy, the creditors would consider themselves fortunate to receive 20 per cent. How much more fortunate is the creditor who accepts a settlement of 40 per cent and leaves the debtor 35 per cent to continue and rehabilitate his business. Moreover, the loss sustained by the creditor may be recouped in future sales to the debtor. This would be quite unlikely, if not impossible, were the debtor forced through bankruptcy. Then, too, bankruptcy proceedings use up the time of all parties and cause many creditors considerable trouble and worry, all of which is dispensed with through the composition settlement.

To summarize, an honest debtor is rightfully entitled to a composition settlement. However, before accepting an offer of settlement the creditors should obtain full and complete information regarding the debtor's affairs, and assure themselves beyond a reasonable doubt that there is an entire absence of fraud. If the credit man discovers any trace of fraud he should absolutely refuse to grant an extension or agree to accept a composition settlement.[1]

Forcing a Composition Settlement on Obstreperous Creditors

Suppose 75 per cent of the creditors agree to accept the terms of composition submitted by the debtor, but the other

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1 Ettinger and Golieb, Credits and Collections, p. 316.

25 per cent refuse? In such a case it is possible to force the proposed settlement upon the other creditors. Suit is filed by three of the creditors in the federal district court to have the debtor adjudged a bankrupt. Then, before the adjudication, the debtor asks for a creditors' meeting for the purpose of considering an adjustment, whereupon the court stays the proceedings.

At the meeting the debtor is first examined by the creditors and then submits his terms of settlement. A majority of the creditors in number and amount then agree to accept his proposition, and petition the court to have it confirmed. In this way the debtor obtains the desired relief without incurring the stigma incidental to being adjudged a bankrupt. Prudent and experienced credit men will always insist upon the money being put up or satisfactorily secured before voting to accept any such proposition.

Liquidation of Business

If an extension is deemed inadvisable and no terms of composition can be agreed upon, there remains but one other course to pursue—wind up the business and distribute the proceeds among the creditors. This result can be accomplished in either of three ways: (1) through the medium of an adjustment bureau, (2) by the debtor making a legal assignment, or, (3) through the bankruptcy proceedings.

Bureau Procedure

The plan of the adjustment bureau, while accomplishing the same purpose as the legal assignment, or bankruptcy proceedings, dispenses with the most objectionable feature of legal process in that it: (1) leaves no stigma attached to the debtor, (2) the incidental expense of administering the estate is usually much smaller, and (3) the proceeds derived from the sale of the assets is considerably larger.

The bureau plan provides for an assignment by the debtor

of all his property to the bureau as trustee. The bureau then takes charge of the assets, and proceeds to dispose of them in one of three ways:

1. It may sell the goods and fixtures at public auction.
2. It may sell the stock in small lots to buyers of bankruptcy stocks and storekeepers at private sale.
3. It may continue the business and gradually dispose of stock at retail.

Whichever method is followed, the creditors are usually compelled to wait at least four months after the assignment before they receive any dividends. This is for the reason that the adjustment bureau does not want to assume any risk should certain previously unheard of creditors appear and demand payment after the debtor's estate has been wound up, but before the four months' period has elapsed. These creditors could file a petition in bankruptcy and set aside the assignment as a preference, and compel the adjustment bureau to account for the money received from the sale of the bankrupt's property and disbursed to creditors. The bureau would then be in a very embarrassing position if it had already distributed the money. It is for this reason that the bureau makes no payments until at least four months after the assignment.

Facilities of Adjustment Bureaus to Conduct Liquidation

Established adjustment bureaus usually have skilled appraisers to place in charge of insolvent estates and special avenues through which stocks of merchandise can be disposed of to greatest advantage. Ordinarily the charges of the bureau do not exceed 7 per cent of the amount distributed to creditors except where services of an unusual nature are rendered. The average return to creditors from liquidations conducted by adjustment bureaus usually varies from 50 to 60 per cent of the amount of their claims as compared with an average return of approximately 25 per cent in bankruptcy.

Consequently, this process of adjustment is rapidly grow-

ing more popular, and adjustment bureaus everywhere are growing in number and importance, as it obviously works to the mutual advantage of both debtor and creditors, in that it requires less time and expense to work out the same result that is accomplished through the legal assignment or bankruptcy. It is also more in keeping with the constructive business policy of the present day—to assist the debtor when he gets into a tight place, or "to try to pull a man out of a hole," and not to try to push him into one—as contrasted with the hasty and intolerant policy of creditors under the same circumstances prior to the enactment of the National Bankruptcy Act, which makes it impossible for one creditor to obtain a preference through legal process within four months prior to the filing of a petition in bankruptcy. In fact, today, once a debtor is in financial straits, any attempt on the part of a creditor to force a settlement of his claim in such a manner as to obtain a preference to the assets at the expense of the other creditors usually results in bankruptcy proceedings being instituted by the other creditors.

Many of the various lines of trade, realizing and appreciating the advantages of such settlements, are organizing within their respective industries for this very purpose, by establishing local representatives or secretaries in all of the larger cities. The National Association of Credit Men has also been instrumental in encouraging such adjustments by establishing local adjustment bureaus within their own organization.

Aims and Objects of Adjustment Bureaus

The affairs of involved debtors are constantly being liquidated through the adjustment bureaus of these local associations, the fundamental aims and objects of which are as follows:

1. To investigate, upon request, the affairs of a debtor reported to be insolvent and adjust the estate, when possible, without court proceedings.

2. To secure capable and efficient receivers or trustees when court proceedings are found necessary.
3. To secure quick adjustment of all honest failures at the minimum cost and with the maximum dividend to creditors.
4. To facilitate and provide for extensions or liquidations when upon investigation it is found to be to the best interests of all.
5. To influence concerted action by the creditors for the benefit of all.
6. To assist creditors to acquire for their own use the estate of failing or insolvent debtors, when mutually agreed upon.
7. To prosecute or assist in the prosecution of the guilty party or parties where investigation discloses fraud or the intent to defraud.

CHAPTER XXXVIII

ASSIGNMENTS

Advantages of Assignment

In the general assignment for the benefit of creditors we find combined many of the advantages of the "amicable adjustment" coupled with some of the legal formalities of bankruptcy. The expense of administration is less than that of bankruptcy proceedings, as under a voluntary assignment there is no limit on the time in which an estate must be settled, so that the creditors may conduct the business as they see fit, and wait for a favorable market in which to dispose of the assets, whereas in bankruptcy it is generally necessary to dispose of the assets at a forced sale, and at a great discount. Furthermore, while greater publicity is given to a formal assignment than is necessary in the case of an adjustment, there is less publicity attached to it than to bankruptcy proceedings, because while the administration of an assignment is practically private, once due notice has been given, bankruptcy proceedings are of course a matter of public record.

State Insolvency Laws

Whether a man could be discharged from his debts depended at one time upon state insolvency laws, but these laws have been superseded by the Federal Bankruptcy Act. Today you cannot obtain a discharge from your debts by operation of state insolvency laws, but only by operation of the United States Bankruptcy Law.

In the absence of Congressional legislation on the subject

of insolvency, the legislation of the respective states is supreme within the jurisdiction of the state. In other words, the mere grant to the federal government of power over a subject does not necessarily extinguish state authority over the same subject. But state insolvency laws apply solely to contracts made within the state. Consequently, the question here is one of proper jurisdiction, and no state has the right or power to exercise authority outside its own jurisdiction. Therefore interstate matters are beyond state jurisdiction and are exclusively under the control of Congress. Expressed judicially, this principle has been stated as follows: "Insolvent laws of one state cannot discharge the contracts of citizens of other states, because they have no extra-territorial operation or effect."

Every state, however, has some form of insolvency law, whereby a debtor may turn over his property to a third party for the purpose of disposal and pro rata division of the proceeds among his creditors; but the laws are not uniform, and the requirements in some states are more exacting than in others. For instance, in some states an act of assignment in itself automatically releases a debtor from further liability, while in others it does not. In most states, however, the law provides that the assignment must be recorded in the county clerk's office in which the debtor resides or has his principal place of business, and, as in bankruptcy, a sworn schedule consisting of a list of creditors and an inventory of the property must be filed in like manner.

The administration of the estate is carried out by the assignee under the supervision of, and subject to the discretion vested in, the insolvency judge, who can authorize the filing of suit for the recovery of property transferred to defraud creditors; the payment of dividends; approval of composition settlements; can restrain the debtor or witnesses from leaving the jurisdiction; in fact he may exercise practically all the powers vested in a court of equity.

An Assignment an Act of Bankruptcy

Perhaps the most important feature to be brought out in this connection is that an assignment, irrespective of the debtor's solvency, as we shall soon learn, constitutes an act of bankruptcy, making it possible for the creditors, by filing a petition under the Federal Bankruptcy Act, which of course supersedes any state law, to take the administration of the property out of the jurisdiction of the state insolvency court and place it in the hands of a trustee in bankruptcy. Creditors seldom avail themselves of this privilege, however, simply because under liberal state laws it has generally been found less expensive to permit the assignee to continue, especially when satisfied of the good faith of the debtor and the honesty and ability of the assignee.

However, it should be remembered that if you consent to the making of an assignment you are estopped from filing such a petition in bankruptcy. So consent to an assignment should be given only when you have absolute faith in the assignee. Although selected by the assignor, the assignee is supposed to act in the interest of the creditors; but the only way in which creditors can bring pressure to bear on an assignee is by making proper application to the court for a report or for an accounting.

Assent on the part of creditors is not necessary to proceed with assignment proceedings; it only serves as a protection to the assignee, in that in the absence of such assent the estate, after settlement, may be thrown into bankruptcy and the court may take exception to some of the expenditures and hold the assignee accountable.

This is a difficult subject to treat owing to the lack of uniformity in procedure and remedy in the different states. The reader will have formed a better conception of assignments after having read the following chapters which pertain to the process of administration and the manner of handling insolvent estates.

Legal Significance

Voluntary assignments for the benefit of creditors are transfers in trust, without compulsion of law, by debtors of some or all of their property to an assignee, to apply the same, or the proceeds thereof, to the payment of some or all of their debts, and to return the surplus, if any, to the debtor. They have the effect of withdrawing the property of the debtor from the legal pursuit of creditors, and are usually resorted to by debtors who find themselves unable to pay their creditors in full, or the embarrassed state of whose affairs has compelled them to discontinue the transaction of business.

Debtor's Right to Assign

The general power or right to assign property in trust on behalf of and for the benefit of creditors has always been recognized and approved in the fullest manner, by both the various state and federal courts. The only checks or restrictions placed on the exercise of the power were the general ones providing for the setting aside of assignments on the ground of fraud.

State Statutes

The privilege thus afforded insolvent debtors has, however, been taken advantage of to accomplish purposes for which it was never intended, and it was the attempt to correct various abuses arising out of this recognized legal right that has led in most states to the enactment of statutory regulations limiting on the one hand the debtor's power in creating these trusts, and defining, on the other, the duties of the assignee in executing them; and at the same time giving the creditors a more effectual power of inspection and control over the acts and proceedings of both. Whereas these statutory provisions differ in the various states, they are concerned largely with such formal requisites as the filing of an inventory and bond, presenting of an accounting by the assignee, the regulation of the time and mode of sale of assigned property, and prefer-

ences made or created by the debtor in contemplation of insolvency.

Insolvency—Meaning and When Important

It is one of the fundamental consequences of the ownership of property that a man may make any disposition of it he may desire which does not interfere with the existing rights of others. So the state statutes which have been enacted for the purpose of restraining the right of making assignments and regulating their operation are confined to assignments made by debtors who are insolvent or acting in contemplation of insolvency. When, therefore, an attempt is made to bring an assignment within the operation of these acts, either for the purpose of having it declared fraudulent and void, or for the purpose of compelling an administration of the assigned property in accordance with its provisions, it becomes essential to establish the fact that the assignment was made by an insolvent debtor or in view of insolvency. This question frequently becomes of great importance in considering the validity of assignments executed by corporations.

Insolvency may be either absolute, in the sense that the entire mass of the debtor's resources, including property of every description, falls short of satisfying his existing obligations; or temporary, in the sense that the debtor is no longer able to meet his obligations as they fall due, in the ordinary way; that is, to satisfy them without resorting to the general mass of his property or fixed assets. To constitute insolvency within the meaning of the various insolvency laws, it is generally held that a debtor's means or entire resources, including not only his quick, but also his fixed assets, must be inadequate for the payment of all his debts.

In addition to the mode of payment, the circumstance of time of payment constitutes an important element in the legal meaning of insolvency. In strictness, the term imparts a present inability to pay; it is descriptive of a present and not a

future condition of affairs. In other words, a debtor may be able eventually to satisfy his obligations in full, but it does not follow that he is not insolvent because of the existence of such an ultimate possibility. On the other hand, a solvent debtor is never entitled to procure a delay by means of a transfer of his property, whether the transfer be by way of a general assignment or otherwise.

Who May be Assignee

The assignment may be made either to one who is a creditor of the assignor, or to one who is not a creditor; and where no assignee is named in the assignment the assignee will be selected by the court. However, the power to select and appoint his own assignee is allowed to every debtor contemplating such a disposition of his property, and in the absence of any statutory restriction he is not bound to consult his creditors or obtain their consent to the appointment, provided the person selected is qualified and capable of performing the duties of the office.

What Property Passes by Assignment

A general assignment for the benefit of creditors is understood to import a transfer of all the debtor's property for the benefit of his creditors. The nature of the relation created by insolvency requires that the transfer should be of this comprehensive character, inasmuch as creditors then have an equitable claim on all the property of their debtor, and it is his duty to devote the whole of it to the satisfaction of their claims.

There are, however, portions of a debtor's property which the law expressly exempts from the process of creditors; and these, of course, he is allowed to except and retain out of the general conveyance. Statutory provision is usually made for these exemptions, but it has been held in several jurisdictions that unless specific reservation of such property is made in the conveyance, the right is waived by the debtor.

Form of Assignment

A writing of some kind is generally required, not only as security against fraud or collusion, but as a necessary means of giving effect to the assignments themselves. The very nature of the transfer, comprehending various descriptions of property, and accompanied by directions more or less numerous and complicated, as to the mode of distribution, renders a written instrument important. Where real property is either wholly or in part the subject of the assignment, a writing is expressly required by statute. In fact, in most states it is expressly required by statute that every assignment for the

KNOW ALL MEN BY THESE PRESENTS, that WHEREAS, I,......of......, am indebted to divers persons in considerable sums of money, which I am at present unable to pay in full, and am desirous to convey all my property for the benefit of all my creditors without any preference or priority.

NOW, THEREFORE, I, the said......, in consideration of the premises, and of one dollar to me paid by......, of......, the receipt whereof is hereby acknowledged, have granted, bargained, sold, assigned, transferred, and set over, and by these presents do grant, bargain, sell, assign, transfer, and set over, unto the said......, all my lands, tenements, hereditaments, goods, chattels, property, and rights in action of every name, nature, and description, wheresoever the same may be, except such property as is by law exempt from execution.

TO HAVE AND TO HOLD the same unto the said......, in trust, to sell and dispose of the said real and personal property, and to collect the said rights in action, with the power to compound for the said rights in action, taking a part for the whole, where the said......shall deem it expedient so to do, and then in trust to apply the proceeds of the said property and rights in action in the following manner:

1. To pay the costs and charges of these presents, and the lawful expenses of executing the trust hereby created, and the wages or salaries actually owing to the employees of the said......

2. To distribute and pay the remainder of said proceeds to the creditors of me, the said......, for all debts and liabilities which I may be owing or indebted to any person whatever; provided, however, that if there shall not be sufficient funds with which to pay all my said debts, then the said debts are to be paid ratably and in proportion.

3. The residue and remainder of said proceeds, if any there be, after paying all my said debts in full, the said......is to repay to me, or to my executors, administrators, or assigns.

IN WITNESS WHEREOF, I have hereunto set my hand and seal, this ......day of......

In the presence of

(*Witnesses' signatures.*) [SEAL]

Form 27. General Assignment for Benefit of Creditors

benefit of creditors should be in writing, and further formalities are in some instances required.

In regard to the particular character of the writing by which an assignment is required to be evidenced, it usually partakes of the character of a deed (Form 27), and is drawn with the same care as any other instrument of conveyance; consisting of two principal parts: (1) a transfer to the assignee, which vests in him the property; and (2) a declaration of trust, which directs him how to dispose of it. The component parts of the transfer are: (1) the commencement, (2) the recital, (3) the consideration, (4) the transfer, (5) description of property, (6) declaration of trust, or directions to assignee, (7) power of attorney to the assignee, (8) covenant by the assignee, and (9) the concluding clause.

To the assignment are usually appended two schedules which are marked and referred to in the body of the instrument, and are accepted as part of it: (1) a schedule of the assigned property, and (2) a schedule of the assignor's creditors, or of the debts to which the property is to be appropriated.

Assignments with Special Provisions—Release of Debtor

Assignments are sometimes drawn with a stipulation for a release of the debtor as the condition of receiving the benefit of the deed; or, in other words, making it a condition that the creditors shall accept the provision made for them in full satisfaction and discharge of their demands. Such a stipulation is in some cases introduced as a condition of receiving any benefit under the assignment, non-releasing creditors being wholly excluded, and expressly reserving the shares of non-releasing creditors to the assignor himself.

As to the validity of such stipulations, the law is not uniform. In some states such a release has been sustained; in others they have been adjudged valid only in so far as they operate to postpone non-releasing creditors to others. In other states they have been pronounced void under all circumstances,

especially where there is an express reservation of the surplus to the assignor.

The objection to the allowance of these stipulations in assignments is that when allowed the debtor surrenders nothing except on his own terms. He attempts to coerce his creditors by withholding from them all his property, unless they accept what he is able to give in discharge of his debts, and thereby succeeds in locking up his property until the creditors comply with his terms.

Reservation of Benefit to the Debtor

"When a debtor fails, his property, in moral justice, belongs to his creditors." Assignments of his property, therefore, considered as modes of provision for creditors, should actually be what they profess to be, for the benefit of creditors, and not for the benefit of the debtor. Hence, it has been generally held that any clause or provision in an assignment whereby any advantage is reserved to the debtor at the expense of his creditors, constitutes fraud, and vitiates the assignment. From this general doctrine it follows that an insolvent debtor can make no assignment of any part of his property in trust for himself, and that all such deeds or transfers are void as against creditors.

Limitation of Time for Creditors to Assent

Assignments are sometimes drawn with a provision requiring the creditors for whose benefit they are made, to assent to them within a limited time. As to the validity of such a reservation, the various state decisions on the point are not in accord. When allowed, however, the time so limited must be a reasonable period. What is to be deemed a reasonable time depends upon the particular circumstances surrounding the case. The period may be either so short or so long as to raise a presumption of fraud. It must be neither too long, so as improperly to delay the creditors in the collection of their

debts, nor so short as not to afford sufficient time for a proper investigation.

The same restrictions apply with respect to the sale of the property assigned, and a clause unreasonably postponing the time of sale of the assigned property will void the assignment. The assignee has a discretion as to the time of sale, but it is a legal discretion subject to the control of a court of equity.

The manner of sale, as well as the time and terms of sale, is almost always left to the discretion of the assignee, who is authorized to sell "in such manner, at such time, and subject to such terms as he shall deem most expedient in the interests of the creditors."

Consideration for Assignments

There can be no question as to whether an assignment of a debtor's property to a trustee, or assignee, for the benefit of his creditors is for a valuable consideration or not, because the debts due to the creditors constitute a valuable and sufficient consideration, and the obligations voluntarily assumed by the assignee or trustee likewise constitute an adequate consideration so far as he is concerned.

The principal trusts of every assignment are to collect the property; to convert it into money by sale, and to distribute the proceeds among the creditors entitled to participate in the assets. But these main trusts are oftentimes varied by the assignor as the circumstances may necessitate, and usually are subdivided into minor trusts, or specific directions pertaining to the disposition of the property.

Execution of the Assignment

The assignment having been properly prepared and the necessary schedules attached, the next step in the proceeding is the execution of it by the persons named as parties. In most cases the instrument is under seal and where it conveys realty, or contains covenants by either party, this formality should not

be omitted. The schedules should be dated and executed, as well as the assignment itself.

The assignment should, in the first place, be executed by the assignor, although it may be done by an attorney acting under a valid power for the purpose. Where the assignee is formally named as a party to the assignment, or the instrument contains any covenant to be performed by him, it is necessary that he should execute it as well as the assignor. But when this is not the case, he need not become a party to it by signing. In other words, an assignment is good, even if the assignee does not execute it or enter into any covenant to perform the trusts. If it is executed by the assignor and delivered to the assignee, and he accepts it and enters upon the performance of the trusts, he is as much bound as if he had executed it.

In some states a formal acceptance by the assignee at the foot of the deed, immediately following the signature of the assignor, is required.

Attestation

The assignment, like all other conveyances of property, should be executed before witnesses, who attest it in the usual manner. In some states it has been made necessary to the validity of an assignment that it should be sworn to by the assignor.

Recording or Registry of the Assignment

Record Essential. In some of the states an assignment is of no validity against creditors unless recorded or registered in some public office within a certain time after its execution.

Where real property is part of the property assigned and is situated in a county other than the one in which the original assignment is required to be recorded, a certified copy of such assignment must be filed and recorded in the county where such property is situated.

Delivery of the Assignment. It is also necessary, in

order to complete the transfer intended by the assignment, that the instrument should be actually delivered to the assignee. Otherwise, it has been held to be fraudulent and void against a creditor who has obtained a judgment. The record of the deed amounts to prima facie evidence of delivery, and the moment an assignment is submitted for recording, the beneficial interest of the creditors is completely vested.

Delivery of Property. The acceptance of the assignment by the assignee after its execution and delivery by the assignor completes the proceedings necessary to the transfer between those parties, so far as the instrument itself is concerned; but there usually remains a very important act to be done, namely, delivery of possession of the property. This should follow as closely as practicable the execution of the instrument. This is particularly desirable in regard to personal property, the real estate assigned passing by mere delivery of the deed.

It is not an uncommon practice, however, for the assignor to retain possession after the assignment; and the general question involved is whether such retention of possession of goods assigned is fraudulent, and therefore void as against creditors. The decisions of the state courts on this point are quite diverse. The general rule has been laid down in the federal courts, however, that unless possession of the property assigned accompanies or follows the deed, such a transfer is fraudulent and void against creditors.

In regard to goods or personal chattels, a constructive or symbolical delivery is allowed where an actual delivery is physically impracticable, for example, where the goods are aboard a vessel, or in possession or custody of some third party under some lawful title.

Assent of Creditors

Where the assignment is made directly to the creditors, their assent is always required to give it validity, on the ground

that it requires the agreement of two parties to make a contract. A debtor cannot change his relation to his creditors by a voluntary assignment of his property to them. If, therefore, he makes an assignment direct to them and his creditors do not accept it, there is no change of property, and legal redress is open to the creditors as before the attempted assignment.

But where the assignment is to a trustee for the benefit of creditors not parties to the deed, the general rule is that the assent of the creditors is not necessary to its validity, and the legal estate or title will pass to the assignee without such assent, so as to prevent a judgment creditor from acquiring a lien by his judgment on the realty, or levying an execution on the personalty.

The assent of the creditors may be given either by formally consenting to the assignment, or by receiving and accepting the benefit of it. Where a specific time is prescribed for the creditors to assent, they must comply strictly with the condition, or they will be excluded from the benefit of the trust.

Where the assent of creditors is required by law, or by the form of the assignment itself, it is not necessary that all should assent, in order to make the instrument valid. The prevailing doctrine seems to be that only the assent of creditors in sufficient number and amount to cover the value of the property assigned is required.

Proceedings by the Assignee

The assignee, on receiving the assignment from the debtor, immediately enters upon the duties of the office by giving public notice of the assignment (when necessary), executing a bond for the faithful performance of the trust and taking possession of the property specified in the schedule. Proper measures are then taken for the collection of the debts assigned and the disposal of the property at the earliest practicable period. Out of the proceeds of the sale, after deduction for the expenses of the trust, distribution is made among the credi-

tors, and dividends are usually paid from time to time as the funds accumulate in the hands of the assignee. If any surplus remains after paying all debts, it is paid to the assignor, and the trust is closed by a general accounting.

The duty of the assignee is to proceed with as little delay as possible, consistent with the best interests of creditors, in converting the assets into money and applying same in the payment of the creditors. In the execution of the trust, he must be governed by the directions contained in the assignment itself (when they are not inconsistent with statutory provisions), subject to such supervision as may be exercised by the proper court; and in general he is bound to manage and execute the trust for the benefit of creditors with the same degree of care and diligence as a prudent owner.

The assignee is personally responsible for an abuse of the trust, and if guilty of misconduct, may be called to account, and if necessary, removed from his office. But he is protected when he acts in good faith, even under a void assignment.

Notice of the Assignment to Creditors

One of the first acts of the assignee on receiving the assignment is to give public notice of it, which is usually done by advertisement in one or more newspapers, stating in substance that the debtor has made an assignment of all his estate to the assignee for the benefit of his creditors, and requesting creditors to present their claims, and debtors to account and make payment to him.

In most states public notice of the assignment is expressly required by statute. On the other hand, in some states the recording of an assignment is held to constitute sufficient notice to creditors.

Object and Effect of Notice

The object of giving notice of the assignment is to give publicity to the transaction for a twofold purpose: (1) to

apprise the creditors of the transfer and to instruct them as to their proceedings to obtain its benefit; and (2) to inform the debtors of the assignor and persons having money or property belonging to him in their hands, of the party to whom they are to account and to pay the same.

A debtor on an open account, after notice of the assignment, cannot defeat the rights of the assignee by making payment to the insolvent debtor.

Effect of Omission of Notice

The neglect of the assignee to give the public notice required by the assignment does not divest the title to the property assigned, and it has been held not to be necessary that the creditors for whose benefit the assignment is made should have notice of it, provided they afterwards assent to the provisions made for their benefit.

Extent to Which Assignor's Business May be Continued by Assignee

As a general rule, the effect of a general assignment of a debtor's property is to put an end to the transaction of his business as ordinarily conducted—to the ordinary operations of purchase, manufacture, and sale. Provision is oftentimes made, however, in the instrument of assignment providing for the continuation of the business for a limited time, with a view to the more beneficial execution of the trust.

Independently, however, of any authority contained in the assignment, the assignee may, in certain cases, continue the business as it has been conducted by the debtor. Thus, where an assignor is conducting a manufacturing business when he makes an assignment, and he has a large amount of material on hand for the purpose of being manufactured, the assignee can conduct the business in his own name for the purpose of working up the material thus ready for manufacture, where it is manifestly for the benefit of the estate. But he cannot con-

tinue the business longer than is necessary for this particular purpose. If he does do so, he does it at his own risk, and may be held accountable for any loss which thereby accrues to the estate.

Sale of the Assigned Property

One of the principal objects of a voluntary assignment of property for the benefit of creditors, and one of the most important duties of the assignee in the execution of the trust, is the sale of the property assigned, in order to convert it into money for the purpose of distribution among creditors. The property must in all cases be disposed of by sale, nor can he appropriate it for his own use, although he charge himself the cost price.

The power to sell is usually expressly given by the assignment. But it is also necessarily implied by every conveyance for the payment of debts.

Duty in Regard to Sale

The assignee is bound to use not only good faith, but also every requisite degree of diligence and prudence in conducting the sale. If reasonable diligence is not exercised in conducting the sale, or he so manages it as to advance the interest of one of the parties to the injury of another, he will be personally liable to make good, to the party suffering from his misconduct, the amount of the loss.

Time of Sale

An assignee is bound to submit the property to sale and to pay over the proceeds to those who are entitled thereto without delay. If he delays unreasonably to sell, this may be evidence of fraud, and the property may be attached or levied upon as the debtor's. On the other hand, it has been held that an assignee is not bound to sell within a particular time, but should use his discretion in the matter in order to obtain the highest price.

Mode of Sale

An assignee, in general, has discretion to sell at public or private sale, as may appear to be in the best interests of creditors. The proper course to pursue, if he cannot sell the property at its fair cash value at private sale, is to sell it at auction, after giving the creditors reasonable notice of the sale; and he cannot delay a sale for the purpose of retailing the goods. Where the deed expressly directs him to sell by public auction, the assignee is bound to conform to that mode of sale.

Terms of Sale

In some of the states the assignee is allowed to sell the property for cash or credit, in his discretion, and the assignment itself frequently gives him this power. In other states the assignee is forbidden to sell on credit, and a deed granting authority to sell on credit will render an assignment void.

Title of Purchaser

A bona fide purchaser for value, without notice, under an assignment that is not void upon its face, cannot be affected by any intended fraud on the part of the assignor. And notwithstanding the invalidity of an assignment as it respects the creditors of the assignor, a sale of goods assigned, made by the assignee before the creditors have obtained a specific lien upon them, to an innocent purchaser for a valuable consideration, is valid. In other words, the doctrine of *caveat emptor* does not apply to the case of a sale by an assignee for the benefit of creditors, whether the property be real or personal.

Expenses of the Assignment

The payment of the expenses is usually provided for in the assignment, and these the assignee is authorized to deduct and retain out of the first funds which come into his hands as proceeds of the assigned property. And even where they are not provided for in the assignment itself, all the necessary

expenses of the assignee in execution of the assignment constitute a lien upon the estate, and he will not be compelled to part with the proceeds until his disbursements are paid.

The principal items of expense or disbursement incurred in the executions of trusts created by voluntary assignments are advertising, insurance, interest, taxes, commissions on sales, salaries and wages of employees, rent, and cost of litigation concerning estate property.

Compensation to Assignee

In addition to the allowance of his expenses and disbursements, the assignment sometimes contains a provision allowing the assignee compensation for his own time and services; and this is either fixed at a definite amount or stipulated for in general terms. Sometimes a compensation is stipulated for by agreement, independently of the assignment.

Where there is no express stipulation or agreement for compensation to the assignee, beyond his expenses, the general rule is that he is entitled to a reasonable compensation, which is construed in most states to mean the same fixed compensation as is allowed by law to executors, trustees, and guardians.

Where the instrument creating the trust, however, fixes a different compensation, or declares that none is to be allowed, that, of course, must prevail.

The compensation of the assignee is to be ascertained and awarded by the proper court upon the rendering of his account. He is not allowed to become a judge of the value of his own services and offset money or goods appropriated from the estate in payment of same even where a compensation is provided.

In regard to fees claimed by the assignee for services rendered as counsel, it has been held that a trustee, or assignee, cannot charge the estate with a counsel fee paid to himself, on the ground that an insolvent assignor cannot give the assignee any portion of his estate for his services, beyond the fixed legal rate of compensation.

Compensation allowed to an assignee is always on the supposition and condition that he properly performs the duties incumbent upon him as assignee. Hence, if he is guilty of gross carelessness or misconduct, or violates the trust, no compensation will be allowed him. If he maladministers and refuses to account, both compensation and expenses may be refused him.

Distribution among Creditors

After deducting out of the proceeds of the sales and collections the expenses incidental to the trust and the amount of compensation allowed for himself by law, it is the duty of the assignee to distribute without delay the surplus funds in his hands among such of the creditors as may be entitled to participate. This may be considered the most important proceeding in the whole course of executing the assignment, to which the principal processes of collection and sale are only preliminary. Distribution comprises the whole object and end of the assignment.

The distribution is made either in one payment, or in successive payments or dividends. But before any payments can be made, it is necessary for the assignee to ascertain what creditors are entitled to payment, and the order in which they are payable.

Where there is difficulty in ascertaining from the assignment the amount of debts payable, and the mode and order of payment, or where there are conflicting claims which it is difficult to adjust, the assignee may apply to the proper court for directions. Such an application on the part of the assignee may be made either by motion or by a bill in equity.

In inquiring for the debts made payable out of the funds in his hands, the assignee looks in the first instance to the description of them in the assignment, or its accompanying schedules, which are regarded as a part of it, so far as they designate the creditors and the amount and nature of the debt.

But such description is not always to be implicitly relied upon, and it has been held not to be conclusive as to the amount of the respective debts, and that the books of the assignor are proper evidence of the amount of the debts due to the creditors. In some states, the creditors have been permitted to introduce other proof explanatory of their claims.

Disposition of Surplus after Distribution

If after the payment of all the assignor's debts which are legally payable under the assignment, there is a surplus of the proceeds of sales and collections remaining in the hands of the assignee, such surplus belongs to the assignor, and the assignee is bound to pay it to him. The surplus in no case belongs to creditors whose claims have been paid. Therefore, where an assignee agreed to collect the assets and pay them over to the creditors, it was held that he was not also to pay to them any surplus after discharging their debts in full. But if the assignee reconvey the property to the assignor before the debts for the payment of which the estate was created have been paid, the reconveyance is void as to all creditors whose debts were provided for by the assignment and remain unpaid at the date of the reconveyance.

Where the assignment imposes certain terms upon creditors as the condition upon which they are to receive its benefits, and all the creditors do not choose to accede to such terms and do not comply with them, it has been held that if a surplus remain after satisfying the claims of the acceding creditors, it belongs to those creditors who have not acceded to the terms of the assignment and a court of equity will award it to them.

Final Accounting and Close of Assignment

An essential part of the duty of an assignee is the keeping of a strict and full account of all his receipts and payments during the course of the execution of the trust; and after all the funds collected have been finally appropriated and paid over

to those entitled to receive them, he should always be prepared to exhibit his accounts to the assignor and the creditors. If an assignee neglects to keep a full and accurate account of the disposition of the trust property, he will be charged with the value of the property sold by him.

In most states the assignee is expressly required by statute to present his account to the designated court for an examination and approval before he can finally discharge himself from the trust, as in the case of executors and administrators.

Accounting in Equity

Even in states where no formal accounting is required by statute, the creditors are always entitled to an account, and if this be refused or insufficiently granted, they may proceed to compel an account by filing a bill in equity, or other equivalent proceedings. The method of procedure upon such accounting is regulated by the practice and rules of courts of equity in the different states. The action may be brought in the name of any creditor in behalf of himself and all other creditors.

Close of the Trust

The time for closing the trust is sometimes fixed by the assignment itself. If no time is specified, the assignee is allowed what may be considered, under all the circumstances, a reasonable time for the purpose. Sometimes the trust will be considered as closed by lapse of time; and after 20 years the law presumes the debts paid and the trust executed so far as respects creditors.

Liability of Assignees

The liability of an assignee is commensurate with the duty which the assignment imposes upon him. Fundamentally, this duty is to observe good faith in all his transactions and to exercise reasonable diligence in the management of the trust. Hence, a want of good faith or of proper diligence will subject

him to liability for any loss which may result from it. For gross misconduct or a violation or abuse of the trust, such as a wilful misapplication of the trust funds in his hands, an assignee is personally responsible and may be dismissed from office.

Negligence, however, is the ground upon which assignees are most frequently held liable. Thus, a trustee is liable for property or money lost by his gross negligence. But an assignee's liability is not confined to gross negligence, nor can it be so limited by any stipulation on his part in the deed of assignment. Consequently, he is liable for every loss sustained by reason of his negligence, want of caution, or mistake, as well as for positive misconduct. On this ground of "ordinary negligence" assignees have been held liable for neglecting to recover debts assigned, for omitting to recover assigned property from the debtor, and for permitting the debtor to retain possession of assigned property and receive the proceeds.

Attitude of the Courts in Dealing with Assignees

In regard to the mode in which assignees are dealt with by the courts, the rule has been laid down that:

> Where trustees act in good faith and with due diligence, they receive the favor and protection of the court, and their acts are regarded with the most indulgent consideration; but where they betray their trust, or grossly violate their duty, or where they have been guilty of unreasonable negligence, their acts are inspected with the closest scrutiny and they are dealt with according to the rules of strict, if not vigorous justice.

The legal presumption always is that a trustee has faithfully executed his trust, until substantial proof to the contrary is submitted.

Proceedings of Creditors—Coming in under the Assignment

Having considered, first, how the trust for creditors is created on the part of the assignor, and, second, how it is

executed on the part of the assignee, there still remains to be considered the rights of creditors, either under the assignment, in opposition to it, or independently of it, and what proceedings it is competent for them to adopt for the enforcement of such rights.

On receiving notice of the execution of an assignment the creditors have one of three alternatives to pursue: (1) accept the provisions made by it; (2) disregard it entirely and proceed as though it had not been made; or (3) reject it as fraudulent or illegal.

If they accept the assignment, they come in under it and proceed to take such steps for obtaining its benefits as may be required of them, either by the provisions of the instrument or by the general rules of law applicable to the case. Where a specified time is prescribed by the assignment for creditors to come in and assent to it, they must comply strictly with the condition and cannot come in after the expiration of the time stipulated. It has been held in such cases, however, that they are not absolutely excluded, but that they can only claim the benefit of any surplus which may remain after satisfying the claims of those creditors who have complied with the terms of the assignment.

Creditors may express their intention to come in under the assignment in several ways: (1) by becoming parties to the instrument; (2) by giving notice to the assignee of their acceptance of it; or (3) by simply presenting their claims for payment.

By coming in under a voluntary assignment the creditors express their election to accept its provisions, and are considered as acquiescing in the disposition directed by the assignor to be made of the proceeds of the property.

Treating the Assignment as a Nullity

In cases of apparent fraud or obvious illegality the course is sometimes adopted of treating the assignment as a "nullity"

and proceeding as though it had not been made. The right to treat an assignment as a nullity is in some states specifically provided by statute. Thus, if an assignment is made with preferences contrary to the statute, it is absolutely void, and the property remains susceptible to attachment by creditors in the same manner as if no assignment had been made. In other states the same right is recognized by decisions of the courts.

Where the assigned property is attached, in such instances the assignee may bring an action of trespass, and this will raise the question as to the validity of the assignment. In some states the validity of an assignment alleged to be fraudulent may be tested in a court of law, upon an issue made between an attaching creditor and the assignee summoned as garnishee.

Proceedings to Set Aside the Assignment

Instead of regarding the assignment as a mere nullity, the usual course taken by creditors when the assignment is regarded as fraudulent and void as against them, is to oppose it by hostile proceedings in the courts, for the express purpose of having it judicially declared void and set aside. If the creditor elects to have it declared void and set aside judicially, the proper procedure consists of filing a bill in equity praying for a decree to that effect. The prayer of the bill is usually also for an injunction to prevent further proceedings under the assignment and for a receiver to take possession of the property or its proceeds.

Who May Oppose the Assignment

This course, however, is not available to all creditors, nor under all circumstances. Thus, none but judgment creditors can attack an assignment as fraudulent or invalid. Furthermore, creditors who have confirmed a fraudulent assignment by receiving a benefit under it, or have become parties to it voluntarily, are estopped from afterwards impeaching it.

If the creditor who opposes the assignment succeeds in

establishing a case of fraud, a decree is made by the court declaring the instrument void, and appointing a receiver, through whom as its officer the court takes possession of the property and appropriates it. Where the assignment is set aside for fraud, the assignee will not be answerable for payments made under it to bona fide creditors before the filing of the bill.

CHAPTER XXXIX

RECEIVERSHIP

General Nature of a Receivership

Where a debtor has total assets which exceed in value his total liabilities, but lacks sufficient cash to meet his bills as they mature, he may seek the protection of the courts from a forced sale of his property by impatient creditors, by making application for the appointment of a receiver for the business. The application may also be made by the creditors; but it not infrequently happens that when the creditors applying for a receiver learn of the true condition of the debtor at the hearing of the application, they agree to an extension and thus save the expense of a receivership. Such a receivership does not constitute an act of bankruptcy because the debtor is not insolvent within the meaning of the bankruptcy act if his total assets at a fair valuation are in excess of his liabilities.

Instead of seeking the appointment of a receiver, the creditors may petition for an injunction to restrain other creditors from impairing the value of the debtor's estate by suits and execution, and if such an injunction will adequately protect the rights of all creditors the court may grant the injunction instead of appointing a receiver.

In most of the states statutory provisions have been enacted which prescribe the functions, powers, and duties of receivers.

Effect of the Appointment of a Receiver

The object sought by the appointment of a receiver is to provide for the safety of property pending the litigation which is to decide the rights of litigant parties. In other words, a

receiver is a person appointed by the court as its representative for the purpose of assuming control over certain property until the court shall decide to whom it properly belongs. He is regarded as an officer of the court appointing him and whatever he does under the orders of the court in respect to the property over which he is appointed receiver is the act of the court itself. He is frequently characterized as the "arm or hand of the court." A receiver has also been characterized as a quasi-trustee holding the property for the benefit of whoever may eventually establish title to it. A receiver differs from an assignee in bankruptcy in that the latter is vested with the legal title to property held by the bankrupt, while a receiver has no such estate but is a mere custodian for the court.

Principles on Which a Receiver Is Appointed

The power to appoint receivers is one vested solely in courts of equity, and the jurisdiction of equity to appoint a receiver is founded on the inadequacy of the remedy to be obtained in the law courts.

In order for general creditors to have a receiver appointed over the property of the debtor, a strong case must be made out because the court will not, unless a clear case be established, deprive a person of property in which the claimant has no specific claim, in order that if he establish his claim as a creditor there may be assets wherewith to satisfy it.

As a general rule, when the object of the action is only to compel the payment of a sum of money, the court will not appoint a receiver upon the filing of the bill. While it is sometimes necessary for the court, through its receiver, to continue the management of the business over which the receiver is appointed, for the purpose of effecting a more satisfactory adjustment and for better protecting the interests of all parties, the courts are generally averse to assuming the management of a business except as incidental to the object of the suit, and for the purpose of closing it up and dividing the proceeds.

When a receiver is appointed at the instance of judgment creditors, it is customary for the court to require the defendant to execute an assignment to the receiver of all his property and effects, which has the effect of placing it beyond levy and execution by judgment creditors.

Selection and Eligibility

In the selection of a person to act as receiver the court exercises a judicial discretion which is governed by certain well-defined principles. In the first place the receiver is an indifferent person to the litigation and not the agent or representative of either party to the action. He is regarded as an officer of the court, exercising his functions in the interest of neither plaintiff nor defendant, but for the common benefit of all parties in interest. Being an officer of the court, the fund or property entrusted to his care is regarded as being *in custodia legis* (in the custody of the court) for the benefit of whoever may eventually establish title thereto. He, therefore, occupies a position of dual capacity: (1) as officer of the court, (2) in his fiduciary relationship to the parties.

The person who is to fill the office of receiver is generally decided upon prior to the making of the motion, and if both parties have agreed upon a proper person, the court will at once insert his name in the decree. If the party proposed as receiver is objectionable, any person interested in the proceedings may propose that some other person be appointed. In making the selection, the circumstances of the case and the interests of all parties must be taken into consideration.

It is regarded as exceedingly objectionable to appoint as receiver over a particular kind of property a person who is entirely unfamiliar therewith, even though he agrees to carry out the directions of another person more familiar with the management of the property, since it is always preferable that the receiver appointed should act upon his own responsibility.

The fact that the appointee resides at a great distance from

the property which is to be subjected to his management and control, while not regarded as an absolute disqualification for the office, is a circumstance which should be taken into consideration in making the appointment. In the absence of statute it is not necessary that the person selected should be a resident of the state in which the suit is pending.

Receiver's Possession

The appointment of a receiver does not in any way determine the rights of the parties to the litigation, and the title to the property does not change by virtue of his appointment. A receiver holds the property coming into his hands by the same right and title as the person for whose property he is receiver. In other words, his possession is not adverse to either the plaintiff or the defendant in the litigation; the primary object being to secure the thing in controversy so that it may be subject to such disposition as the court may finally direct. The possession of the receiver is not unlike that of the sheriff over property which has been levied upon under an execution or attachment.

It is important to note that the receiver's possession is subject to all valid and existing liens upon the property at the time of appointment, and does not divest a lien previously acquired in good faith. And when creditors have obtained judgments against their debtor, which are a lien upon his property, prior to the appointment of a receiver, the receiver takes subject to such liens. So, where creditors obtain judgment and levy upon the property of the debtor and a receiver is afterwards appointed who takes possession of the property and sells it, the sheriff who made the levy is entitled to the proceeds of such sale. Likewise a receiver cannot maintain replevin for property which has been levied upon and reduced to possession by creditors having a paramount lien.

The receiver's possession being the possession of the court from which he derives his appointment, he is not subject to

the process of garnishment as to funds in his hands or subject to his control, and such process will be regarded as a nullity when directed against him. And when a receiver is appointed of the effects of a partnership in an action brought by a creditor of the firm, he cannot be garnisheed by judgment creditors of the firm as to partnership assets in his hands, such assets not being subject to garnishee process.

Suits against Receivers

The possession of the receiver being, as already shown, regarded as the exclusive possession of the court from which he derives his appointment, the courts are extremely averse to allowing any unauthorized interference therewith, and will not tolerate any attempt to disturb him in his rightful possession without leave of the court being first obtained for that purpose. A person who brings an action in one court against a receiver appointed by another court without the consent of the court whose officer such receiver is, is guilty of a contempt of the latter court.

The proper practice in such case is for a person having a demand against the funds in the hands of the receiver to bring his demand in the court appointing the receiver and the court will direct him to be examined before a referee, and if, upon auditing his accounts, the court finds the claim to be a just one, it will direct the receiver to pay it without litigation. If, on the other hand, the court finds the claim to be a doubtful one, it will give the claimant leave to prosecute it against the receiver before some competent court.

A state statute providing that all receivers appointed by any court may be sued without leave of the court appointing or controlling them, can have no application to receivers appointed by the federal courts.

All books, documents, and papers in the hands of a receiver, however, are quasi-public in character, and are open to examination by creditors.

Cases in Which a Receiver Will be Appointed

There are four general classes of cases in which a court will appoint a receiver:

1. Where there is no person competent by reason of interest, or otherwise, to take the custody and management of the property which constitutes the subject matter of litigation.
2. Where, although all of the parties may be equally entitled to possession and control of the property, still it is not proper that either of them should have possession or control of it.
3. Where the person holding the property occupies a position of trust relation and is violating his fiduciary duties.
4. Where after the rendition of a judgment or decree, the ordinary processes of the court cannot carry the judgment or decree into effect.[1]

To warrant the appointment of a receiver, it is essential that the plaintiff should show: (1) either a clear legal right in himself to the property, or that he has some lien on it, or that it constitutes some special fund out of which he is entitled to satisfaction of his demand; or (2) that possession of the property was obtained by the defendant through fraud, or that the property itself, or the income from it, is in danger of loss from the neglect, waste, misconduct, or insolvency of the defendant.

Where the court is of the opinion that the plaintiff is entitled to have a receiver appointed to take charge of the property in litigation, but feels that the plaintiff would be made secure in event of recovery by the furnishing of a bond by the defendant, it is within the discretion of the court to make an order refusing to appoint a receiver upon condition that the defendant furnish such a bond.

[1] Tardy's Smith on Receivers, page 23.

In the absence of statute the mere insolvency of the defendant, without any other ground being stated as a cause of action, will not of itself be sufficient for the appointment of a receiver. Insolvency is, however, one of several reasons for appointing a receiver, but it is further predicated on the general doctrine of probable loss. Consequently, there must be coupled with an allegation of insolvency, additional allegations showing the plaintiff's probable right of recovery and that such recovery will be lost or substantially jeopardized by reason of the insolvency unless a receiver is appointed.[2] The court will be influenced greatly by what in its opinion are considered the prospects of the plaintiff's recovery. If the indications are clearly favorable, the risk of injury to the defendant is small, and the court will consequently not be so hesitant to interfere. A receiver may, however, be appointed in a proper case, notwithstanding that the defendant is perfectly solvent.

An important principle in the application of this power is that the plaintiff is never entitled to a receiver when the equities of the case are fully denied by the sworn answer of the defendant, unless the evidence submitted in support of the bill is sufficient to overcome such denial.

Receiver for a Partnership

Where an application is made for a receiver in partnership cases, the situation with which the court is presented is this: If it grants the motion, the effect of it is to put an end to the partnership; whereas if it refuses the motion, it leaves the defendant at liberty to continue the partnership business at the risk and possibly irreparable loss of the complainant. In granting the application, the court takes the affairs of the partnership out of the hands of all the partners and entrusts them to a receiver or manager of its own appointment. It excludes all the partners from taking any part in the management of the concern.

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2 *Ibid.*, page 59.

Receiver for a Corporation

The appointment of a receiver for a corporation has been likened to the remedy of "equitable execution," whereby the court obtains absolute control of the corporate property. In most states the jurisdiction of the courts of equity over corporations has been extended by statute to the extent that receivers may be appointed to wind up the corporate affairs and to the forfeiture of its franchise. While these legislative enactments vary greatly in the different states, their general purpose and scope are to provide a more effectual method for the protection of creditors and stockholders. However, certain well-defined principles have been established.

In the first place, in the absence of express statutory authority the jurisdiction of courts of equity does not extend to the power of corporate dissolution. The courts are therefore loath to sequestrate the effects of the corporation, or take the management of its affairs from the hands of its own officers and entrust it to the control of a receiver of the court upon the application of either creditors or stockholders.

Where a statute authorizes the court upon application of any judgment creditor of a corporation, after execution returned unsatisfied, to sequestrate the property, stock, and choses in action of the corporation and to appoint a receiver, the statute will be strictly construed, since the exercise of this authority involves the virtual dissolution of the company, If, however, the corporation is insolvent and its directors have been guilty of fraudulent mismanagement of its affairs, a fit case is presented for a receiver in order to preserve the property for the benefit of its creditors and stockholders.

The right of judgment creditors of a corporation to a sequestration of the corporate effects and to a receiver in aid of their judgments at law after execution returned unsatisfied, is a right which is given by statute in most states. It is inconsistent with the scope of this work to enter into a discussion of these various statutes, but it may be stated as a

general proposition that a creditor of a corporation is not entitled to the aid of equity in the enforcement of his demand when he can obtain full and adequate relief at law. In the case of a corporation transacting a large business and where large interests are involved, the court may prevent interference by a judgment creditor seeking enforcement of his judgment by permitting the defendant to give security in lieu thereof.

The primary object of receivership proceedings against insolvent corporations being to preserve the assets for the benefit of creditors, the court will, as a rule, decline to appoint a receiver, although the corporation is insolvent, if its directors, who are trustworthy persons, are clearing up its affairs and where the creditors and stockholders, except the complainant, are satisfied with the management of the directors.

As regards the effect of appointing a receiver of an insolvent corporation upon the rights of creditors, the decisions are not harmonious. As a rule, however, such appointment does not affect or impair a lien already acquired by the creditor upon assets of the corporation, and a creditor who has acquired a lien by attachment will be allowed to retain it, notwithstanding the subsequent proceedings. Nor does such appointment prevent the general creditors from enforcing their demands by suit when it does not appear that the appointment was made with a view to a settlement but only to provide for the safety of the assets pending the litigation.

When a receiver has been appointed under a statute authorizing receivers in case of insolvency, it is proper for the court to discharge him upon motion of the defendant corporation, upon its satisfying the court that it is in solvent circumstances and able to resume business, and that the best interests of the creditors will thereby be secured.

Principles on Which the Relief Is Granted

The first general principle is that a judgment creditor seeking the aid of the court by the appointment of a receiver

must have used due diligence in the assertion of his rights. The bill must therefore be filed within a reasonable time after the execution has been returned unsatisfied.

Another leading principle is that the plaintiff must have completely exhausted his remedy at law for the enforcement of his judgment. And when the bill itself shows that the defendant is in possession of property which is subject to levy and sale under execution, and that there is no obstacle in the way of enforcing the judgment by the usual process at law, no ground is presented for the appointment of a receiver. It therefore follows that the jurisdiction of equity will not be exercised in favor of mere general creditors whose rights rest only in contract and are not yet reduced to judgment, and who have acquired no lien on the property of the debtor.

Fraudulent assignments of his property by a judgment debtor for the purpose of hindering and defeating his creditors, are frequently made the foundation of an application for a receiver in behalf of judgment creditors. Where it is shown that the judgment debtor has made such an assignment to an assignee who is known to be insolvent, such a breach of trust warrants the court in appointing a receiver of the property assigned. Especially will such relief be granted when the debtor himself continues in possession of the property.

Functions of Receiver in Proceedings Supplementary to Execution

The appointment of a receiver is also frequently resorted to as a means of assistance to judgment creditors after execution has been returned unsatisfied, in two well-established lines of cases:

1. Creditors' Suits to Set Aside Fraudulent Conveyances. The purpose of the suit in this class of cases is to have the impediment declared fraudulent and void as to the plaintiff and thus open up the way to the effective sale of the property under the law process. If there is in the hands

of an assignee a surplus over and above what is necessary to satisfy the claims of the creditors, the surplus may be reached by garnishment.

2. Creditors' Suits to Reach Assets Not Accessible under Legal Process. "The principle being established that every species of property belonging to a debtor may be reached and applied to the satisfaction of his debts, the powers of the court are perfectly adequate to carry that principle into full effect. The purpose of the courts in this second class of cases is to subject 'equitable' or non-executionable interests or assets of the debtor to the payment of creditors' claims."[3]

The function of a receiver when appointed in this class of cases is regarded as that of a trustee for the creditors only in whose behalf he was appointed, and, consequently, he can maintain his action only to the extent necessary to satisfy their judgments and no further.

Since a receiver in proceedings supplementary to execution acquires title to the debtor's property by virtue of his order of appointment, his title takes precedence over that of a judgment creditor who levies an execution subsequent to the receiver's appointment. The receiver may therefore maintain an action to recover property so levied upon.

The fact that the debtor has made an assignment for the benefit of creditors does not prevent a non-assenting creditor from maintaining an action to secure the satisfaction of his judgment. And when the receiver of a judgment debtor brings an action to set aside an assignment made by the debtor for the benefit of his creditors, it is proper for the court to permit the assignee to continue in possession and to liquidate the estate of the debtor. The assignees, under such circumstances, are regarded in the light of special receivers and bound to comply with such further orders pertaining to the proceeds as the court may make. This doctrine applies only when the receiver

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3 Tardy Smith on Receivers, pages 653-659.

fails to show that the assignment was made to delay, hinder, or defraud creditors.

Powers of Receiver

The office of receiver is treated as one of confidence and trust, although his discretionary powers are limited. He is not an assignee of the estate over which he is appointed, being simply an officer of the court appointed to take charge of the property pending the litigation. If he is empowered to continue the management of the business over which he is appointed, he may employ such persons as may be necessary for this purpose.

The appointment of a receiver over property does not alter or affect the rights of the parties as regards the operation of the statute of limitations. A payment made by the receiver to one of the parties in the cause out of funds collected by him in his receivership, is not to be regarded as a payment made by the debtor to the extent of being an acknowledgment of the indebtedness so as to take the case out of the statute of limitations, since such payment is made by the receiver in his official capacity and as an officer of the court.

A receiver being always regarded as an officer of the court and at all times subject to its direction and orders, it is proper in the discharge of his official duties that he should on suitable occasions apply to the court for instructions in advance; and he is at all times entitled to such advice from the court and should not hesitate to apply for it when questions of difficulty arise. When such an application is made notice should be given to all parties in interest.

A receiver cannot purchase for his own benefit property connected with or forming a part of the subject matter of his receivership. The courts will not permit him, any more than any other trustee, to subject himself to the temptation arising from a conflict between the interest of a purchaser and the duty of a trustee.

Courts of equity are inclined to exercise a strict control over their receivers in the matter of allowing them to bring suits concerning the receivership, and an action brought by a receiver is considered as having been brought under the order of the court itself. The usual practice is for the receiver to apply to the court for leave to bring such actions before instituting suit. There is a conflict of authority as to whether, in the absence of statutory authority, a receiver may institute and conduct actions in his own name, or whether he must sue in the name of the original party in whose favor the action accrued. The weight of authority, however, seems to be that he must sue in the name of the party having the legal right.

General Duties and Care Required of a Receiver

The broad general duties of a receiver are to take charge of and safely keep and account for all property over which he is appointed receiver, and to obey all orders of the court having control of the receivership. Persons dealing with the receiver are therefore chargeable with notice of the fact that his powers are thus limited.[4]

Where parties to the record are directed by the order to deliver up to the receiver the possession of such parts of the property as are in their holding, the receiver as soon as his appointment is complete should apply to all such parties to deliver up possession accordingly. If possession is withheld from the receiver, an application is then made by motion and directed to the sheriff of the county wherein the property is situated, to put the receiver in possession in pursuance to the order. The "writ of assistance," as it is called, is issued and executed in the same manner as the ordinary "writ of execution."

If the property is in the nature of a chose in action or debt, the receiver should give notice of such refusal to the court in order that the necessary steps may be taken to enforce the

[4] Tardy's, Smith on Receivers, page 197.

court's order, as the sanction of the court must be obtained to the receiver putting them in suit.

Liabilities of a Receiver

Before entering upon the performance of their duties, receivers are usually required to execute a bond for the faithful performance of their duties, with adequate security, the amount and security for which is usually determined by the court with due regard to the value of the property to be entrusted to his care and management.

A receiver is responsible for his acts directly to the court appointing him, and this responsibility continues until he is finally discharged. This immediate and direct responsibility to the court, however, does not relieve him from liabilities which he may incur toward third parties. Where a party to the cause, who is interested in the funds in the receiver's hands, ascertains that the receiver has made improper payments, or has misapplied the funds or any portion of them, he may apply to the court for relief at any stage of the cause, and it is not necessary that he should wait until the receiver submits his accounts and then have the improper payment disallowed.

The receiver being appointed for the benefit of all the parties in interest, and being an officer of the court, he is liable for any fraud or negligence of his own whereby injury accrues to the property entrusted to him. The liability of a receiver to the court appointing him does not terminate until his discharge.

Salary and Compensation of a Receiver

A receiver will, unless it is otherwise ordered, or unless he consents to act without a salary, be allowed a proper compensation for the performance of the duties imposed upon him by law by virtue of the appointment. In the absence of statutory regulation, the matter of compensation is left entirely within the discretion of the court from which he derives his appoint-

ment, to be determined, in accordance with the circumstances of the particular case, and constitutes a part of the costs of the litigation. In many, if not most, jurisdictions there is no statute fixing the amount of the fee or compensation to be allowed a receiver. Where the fee is fixed by statute it usually consists of a certain percentage of the funds received and disbursed by the receiver.

Receiver's Accounts

Receivers, being officers of the court appointing them, are required to account to the court for all receipts and disbursements in the course of their receivership, and courts of equity are disposed to hold receivers strictly accountable in rendering their accounts. A receiver will not ordinarily be permitted to make any expenditures which will seriously diminish the fund entrusted to his charge, without the sanction of the court, and it is his duty to apply to the court for instructions as to expenditures and to keep regular accounts of all items of receipts and expenditures, and must submit satisfactory vouchers against the fund entrusted to his keeping.

A receiver cannot be compelled, pending litigation, to account to a party to the suit, or to furnish him with statements showing the status of his accounts. He is only required to account to the court from which he derives his appointment, of which duty a party to the suit may avail himself by motion made to the court.

When a receiver is charged with having allowed and paid, under order of the court, claims which are fictitious and unfounded, the proper practice for a creditor desiring to contest such allowances is to apply to the court to be made a party to the suit in which the order was made, and to have such order vacated. But once a receiver's accounts have been approved by the court, they are only assailable by direct proceeding or petition calling attention to some error, fraud, or mistake in the accounts.

Removal and Discharge of Receivers

The power of a court of equity to remove or discharge a receiver whom it has appointed may be regarded as well settled, and it may be exercised at any stage of the proceedings, the authority to call such officer into being necessarily implying: (1) the authority to terminate his functions when their exercise is no longer necessary, or (2) to remove the incumbent for an abuse of those functions.

As regards the power of a court of equity to remove for cause and to substitute another in his stead, it is a matter properly resting in the discretion of the court and hence to be governed by the circumstances of each particular case. It is competent and not unusual for the court to remove one receiver and appoint another by consent of all the parties when the proceedings are bona fide and when there is no attempt to traffic in the receivership.

As regards the question of the final discharge of a receiver, as distinguished from his removal for cause, it may be laid down as a general proposition that when the necessity for the office has ceased to exist, the office itself must terminate and the receiver be discharged. In other words, the functions of a receiver usually terminate with the conclusion of the litigation in which he was appointed. It is to be observed, however, that the termination of the litigation does not discharge the receiver *ipso facto,* but in consequence of a formal order of the court.

A receiver, being appointed in the interest of the parties to the action rather than his own, is not entitled to a discharge upon his own application, since the court will not permit the parties to be put to the expense and inconvenience of a change simply because the receiver desires to be relieved of his trust, but will be required to show some justifiable cause for the granting of his application.

As regards the effect of the discharge of a receiver upon liabilities incurred by him during his receivership, it is held

that the discharge does not constitute a bar to bringing an action against him on account of such matters when the liability incurred is sufficient to create a cause of action. For example, when a receiver has taken possession of property belonging to third persons, and has sold it under and by virtue of his receivership, and after notice of the rights claimed by such persons, the court will permit them to bring an action, notwithstanding his discharge, especially where they were not notified of the application for his discharge.[5]

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[5] For a more detailed and complete treatment of this subject consult High on Receivers, and also Tardy's Smith on Receivers.

CHAPTER XL

BANKRUPTCY

Bankruptcy Legislation

In this connection the writer could suggest nothing more discouraging than a reading of the Bankruptcy Act, for rest assured it lacks a lot of reading like a novel. Nor is this surprising when it is remembered that the act was drafted with a view to being construed by trained legal minds rather than the average business man. And yet, as Remington, the well-recognized authority on bankruptcy, says, there never was a law less understood by the average citizen, and less appreciated by business men who are its chief beneficiaries.

Fortunately, however, it is not necessary to make an exhaustive study of the entire act for a creditor to ascertain his rights and gain a general knowledge of the procedure through which the administration of a bankrupt's estate passes, and only those sections with which every credit man should be familiar will be quoted and discussed in this chapter.

A brief glance at its English origin and the subsequent development of bankruptcy legislation will suffice to show its intimate relationship to trade and commerce.

The first bankruptcy act was passed during the reign of Henry VIII, and like the other early bankruptcy laws, was intended solely for the benefit of creditors. A bankrupt in those days was considered in much the same light as a quasi-criminal. The early laws did not provide that he should have the right to petition himself into bankruptcy and be relieved of his debts; they simply provided that under certain conditions his creditors could throw him into bankruptcy and divide what-

ever assets he possessed. As for the unpaid balance, he had to pay that as best he could, and in event he did not pay it, he went to jail. All of the early bankruptcy laws provided either imprisonment or the death penalty for the debtor. In fact, the death penalty for those who failed to pay their debts was common up to the nineteenth century.

During the nineteenth century, however, the relation between debtors and creditors underwent a decided change, due to the fact that the spirit of commercial interdependence had given rise to the idea that the grantor of credit is in a measure a partner of the debtor. In accordance with this development of a more humanitarian feeling toward insolvent debtors, later laws were passed to enable debtors who had surrendered all their property to escape imprisonment. Along toward the close of the nineteenth century, legislation was enacted which enabled honest debtors to obtain a discharge from the unpaid portion of their obligations.

Turning now to the United States, we find that article 1, section 8, of the United States Constitution provides:

> Congress shall have power to establish . . . . uniform laws on the subject of bankruptcy throughout the United States.

Under the power thus granted, Congress has enacted four different bankruptcy statutes: one in 1800; one in 1841; one in 1867; and the statute of 1898, which continues in effect at the present time.

Effect of a National Bankruptcy Law on State Insolvency Laws

It is clearly established that when no national bankruptcy law is in force, the respective states possess full power to pass bankruptcy laws, and as Professor Williston has stated: "The only limitation at such a time on the power of the states is the constitutional prohibition against impairing the obligation of contracts." He has further pointed out that:

> Owing to this prohibition, even though no national bankruptcy law is in force, a state cannot by a bankruptcy or insolvency law discharge a debt arising either from a contract entered into before the enactment of the state law in question, or under a contract made without the state. But the powers of the states, when congress has enacted a national bankruptcy law, are by no means so clear. It is indeed agreed, however, that the federal law is paramount and that the states must yield to its authority if collision arises.

The most important question that arises in this connection relates to laws regulating general assignments for the benefit of creditors, and more particularly as to whether, upon assigning all his property for the benefit of his creditors, the debtor may be discharged from further liability for his debts then existing.

That the right to make a general assignment for the benefit of creditors is not precluded by the passage of a Federal Bankruptcy Act, has been definitely established by the Supreme Court of the United States.[1] Such an assignment takes effect, not from any statute, but from the common law principles governing conveyances and trusts. If the owner of property may convey it to a trustee for one person, he may convey it to a trustee for any number of persons; that is, he may convey it to a trustee through an assignment for the benefit of all his creditors.

Prior to the enactment of the Bankruptcy Act of 1898, most states had enacted legislation pertaining to the making of general assignments, and in some states the debtor making the assignment was discharged from further liability to creditors who actually proved their claims. A few states went still further and allowed the debtor a discharge from all provable claims. That so much of these statutes as related to the debtor's discharge is suspended by the federal act is well settled. However, it has also been decided by the Supreme Court that the

[1] 91 U. S. 496.

suspension of this portion of the statute does not necessarily invalidate the statute itself.[2]

Purpose of Bankruptcy Legislation

"What is the purpose of a bankruptcy law?" asked the Attorney-General of England in introducing the English Bill of 1869. "The object," he answered, "is to collect the proceeds of estates of bankrupts and to distribute them among the creditors as fairly, cheaply, and speedily as possible."

In America, unfortunately, bankruptcy has come to be regarded as a sort of poor debtor's law, as a sort of clearing house for the liquidation of debt, whereby certain debtors at intermittent periods receive emancipation, are rehabilitated, and the "dead wood" of the community is thereby eliminated.

When the question of bankruptcy legislation was first considered in Congress, one ardent champion of bankruptcy legislation argued that:

> The necessity of a bankruptcy law results wherever a nation is in any considerable degree commercial. No commercial people can be well governed or exist without it. Its necessity arises from the nature of trade and is founded on the principle that commerce is built on great credits, and great credits produce great debts. Owing to the risks arising from these and other circumstances, the most diligent and honorable merchant may be ruined without committing any fault. These circumstances make a bankrupt law necessary to the merchants.

The purpose of our present-day bankruptcy proceedings is not only to effect a distribution of the bankrupt's assets equitably among the creditors, but to also discharge those taking advantage of the law from the burden of their obligations, even though the assets are insufficient to pay all claims, leaving no balances to be paid once a discharge is granted, the theory being that it is more expedient from a social standpoint to relieve an honest debtor of the load of debt which makes him

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[2] 108 U. S. 379.

a drone and to save him from going to either an asylum or an almshouse. This does not mean, however, that the debtor is no longer indebted to his creditors, for the moral obligation continues, but rather that it is deemed to be for the best interests of social and business welfare to protect a man under such circumstances, to such an extent as to relieve him from the pressure of his creditors—analogous in effect to the Statute of Limitations as applied to other debts.

1. Suppose you hold A's promissory note for $500, but for some reason you delay suing him for payment of the note for ten years. Under the Statute of Limitations you can no longer sue A—you have "slept on your rights" too long. The Statute does not say that A no longer owes you $500, for if the debt was good when incurred, the personal obligation continues until satisfied; it merely says that the court will not countenance such old claims, and your only recourse lies in an appeal to the debtor's moral sense of obligation.

2. Suppose A is indebted to you to the extent of $500 at the time he goes into bankruptcy. The Bankruptcy Act provides that upon turning over all of his property for the benefit of his creditors the bankrupt may be discharged from further legal liability for his existing debts. It does not say that A no longer owes you the unpaid balance on your claim. It merely says that A can no longer be held *legally* liable for the unpaid balance, and, again, your only recourse lies in an appeal to the debtor's moral sense of obligation. Nor is it uncommon for a bankrupt to recognize the unpaid portion of such claims as still existing debts of honor and to pay off such unpaid balances even after receiving a discharge in bankruptcy. The commercial integrity of such a man is thereafter firmly established in the community and entitles him to credit above others who are of equal financial strength.

Nature of the Proceedings

To accomplish its purpose the act provides for:

1. Taking possession of the assets of the insolvent debtor, either upon his own request or that of the creditors, when justified.

2. The investigation of any apparent irregularities in the conduct of the business.
3. The sale of the assets and distribution of the proceeds among the creditors.
4. Granting him, in the absence of fraud, a discharge from the unpaid balance of his debts.

The various steps incidental to the administration of a bankrupt's estate may be stated briefly as follows:

1. Petition is filed, together with a schedule of the assets and liabilities, in the federal district court.
2. Court adjudges the petitioner a bankrupt and refers the case to the referee for administration.
3. The referee notifies the creditors of the adjudication.
4. Creditors file proofs of debts, covering their claims with the referee.
5. Meeting of the creditors is called by the referee.
6. Creditors elect a trustee to handle the estate under supervision of the referee.
7. Examination of the bankrupt by the creditors.
8. Trustee winds up the estate and prorates the assets among the creditors.
9. Trustee submits a final report to the referee for approval.
10. If approved, the report is submitted to the court, by whom the discharge is granted.

Voluntary and Involuntary Bankruptcy

Before proceeding further with the discussion it might be well to point out the difference between what is termed "voluntary" and "involuntary" bankruptcy. Fundamentally, the distinction is simply this: In the former instance the debtor himself requests of the court that he be adjudged a bankrupt, whereas in the latter he is forced into bankruptcy by his creditors against his will.

The act provides that anyone, regardless of the amount

owing, may file a petition in bankruptcy, with four exceptions: banking, insurance, railroad, and municipal corporations. These are excepted on grounds of public policy for obvious reasons. In event of any of these institutions becoming insolvent, creditors can apply to a court of equity for the appointment of a receiver to take charge of the assets on behalf of the creditors.

Although it is immaterial how small may be the amount the person may owe when he makes his application to be adjudged a bankrupt, the expense of the proceedings affords an effectual bar to small debtors taking advantage of the privilege, and it is not usual for anyone to make a voluntary application unless he is insolvent and being harrassed by his creditors. Under such circumstances, however, it is sometimes better for the debtor to anticipate the inevitable and end the unavailing struggle by requesting the court to adjudge him a bankrupt.

There are two ways in which creditors can close a bankrupt's business and force an application of his property to the payment of their claims. The first is to bring a suit in equity to have a receiver appointed, who then takes charge of the business, sells the property, and divides the proceeds among the creditors under the direction of the court. The difficulty with the proceedings in equity is that if any of the other creditors start proceedings in bankruptcy, the equity proceeding fails and all creditors must come in under the bankruptcy proceedings. The second way is to institute bankruptcy proceedings in the federal district court.

Acts of Bankruptcy

It is only under certain conditions, however, that anyone may be forced into involuntary bankruptcy by his creditors. He must not be a wage-earner (one whose compensation does not exceed $1,500 a year), or a farmer. It must also be proved that the debtor: (1) owes at least $1,000, (2) has been a

resident of the judicial district in which the petition is filed over three months, and (3) has committed one of the five acts of bankruptcy. The act provides that a petition may be filed against a person who is insolvent and who has committed an act of bankruptcy within four months after the commission of such act.

The five acts of bankruptcy set forth in Chapter III, section 3, paragraph (b) consist of the following:

1. Having conveyed, transferred, concealed or removed or permitted to be concealed or removed any part of his property with intent to hinder, delay, or defraud his creditors, or any of them; or
2. Transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors; or
3. Suffered or permitted, while insolvent, any creditor to obtain a preference through legal proceedings, and not having at least five days before a sale or final disposition of any property affected by such preference vacated or discharged such preference; or
4. Made a general assignment for the benefit of his creditors, or, being insolvent, applied for a receiver or trustee for his property or because of insolvency a receiver or trustee has been put in charge of his property under the laws of a State, of a Territory, or of the United States; or
5. Admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt on that ground.

In such instances Chapter VI, section 59, paragraph (c) provides:

> Petitions shall be filed in duplicate, one copy for the clerk and one for service on the bankrupt.

and Chapter III, section 3, paragraph (e):

> Whenever a petition is filed by any person for the purpose of having another adjudged a bankrupt, and an application is made to take charge of and hold the property of the alleged bankrupt, or any part of the same prior to the adjudication and pending a hearing on the petition, the petitioner or applicant

> shall file in the same court a bond with at least two good and sufficient sureties who shall reside within the jurisdiction of said court, to be approved by the court or a judge thereof, in such sum as the court shall direct, conditioned for the payment, in case such petition is dismissed, to the respondent, his or her personal representatives, of all costs, expenses and damages occasioned by such seizure, taking, and detention of the property of the alleged bankrupt.

Proceedings in Bankruptcy

In both voluntary and involuntary bankruptcy the proceedings are begun by the filing of the petition. But in the case of involuntary bankruptcy proceedings especially, it is not unusual for the petition to request the appointment of a receiver to protect the property until a trustee is elected. If the bankrupt in such instances elects to contest the proceedings, a jury trial is necessary before the court can pronounce him a bankrupt. Usually such suits are not contested, and at the expiration of the 20 days which the bankrupt is given in which to reply, the court enters a decree adjudging him a bankrupt. No one is technically a bankrupt until he has been adjudged a bankrupt by a court upon which the legislature has conferred bankruptcy jurisdiction.

However, once adjudged a bankrupt, the administration of the estate is practically the same in both instances.

For administrative purposes, each state is divided into what are known as judicial districts and each district subdivided into two or more divisions, each comprising so many counties, etc. Proceedings are carried on under the general supervision of the judges of the United States federal court, and usually in the federal building of the most important city in the division.

The petition is made out on a prescribed legal form providing for:

1. Statement of the creditors to be paid in full, to whom priority is secured by law.
2. Statement of creditors holding security.

3. Statement of unsecured claims.
4. Statement of liabilities.
5. Statement of assets, in which is listed:
    (a) Realty
    (b) Personalty
    (c) Choses in action
    (d) Property held in trust
6. Statement of property claimed as exempt.
7. Oath in verification as to truthfulness of the statement.

With reference to exemptions the law provides in Chapter III, section 6:

> This act shall not affect the allowance to bankrupts of the exemptions which are prescribed by the State laws in force at the time of the filing of the petition in the State wherein they have had their domicile for the six months or the greater portion thereof immediately preceding the filing of the petition.

The prepared petition is then filed with the clerk of the district court in which the bankrupt resides, for which a fee of $30 is prescribed, $15 of which goes to the referee, $10 to the clerk, and $5 to the trustee. As to who may file the petition, Chapter VI, section 59, paragraphs (a) and (b) provide:

> Any qualified person may file a petition to be adjudged a voluntary bankrupt.
>
> Three or more creditors who have provable claims against any person which amount in the aggregate in excess of the value of securities held by them, if any, to five hundred dollars or over; or if all of the creditors of such person are less than twelve in number, then one of such creditors whose claim equals such amount may file a petition to have him adjudged a bankrupt.

The clerk having made the necessary entries, the petition is submitted to the court, who, upon approving it, adjudges the petitioner a bankrupt (after the expiration of the 20 days) and directs the referee to proceed with the administration of the estate; or in event of an involuntary petition being filed,

directs the clerk to issue a subpoena, which is served by an officer of the court.

Referee in Bankruptcy

The referee is an officer of the federal court, appointed by the district judge for a period of two years, to supervise the administration of bankrupt estates within an assigned territory. His duties begin just as soon as the insolvent has been adjudged a bankrupt, and continue up to the time a discharge is granted. All proceedings incidental to winding up a bankrupt's estate take place before the referee acting in the capacity of "judge in bankruptcy." His first duty is to notify every creditor of the adjudication and call a creditors' meeting for the purpose of electing a trustee, the time for which is provided for in Chapter VI, section 55, as follows:

> The court shall cause the first meeting of the creditors of a bankrupt to be held, not less than ten nor more than thirty days after the adjudication, at the county seat of the county in which the bankrupt has had his principal place of business, resided, or had his domicile; or if that place would be manifestly inconvenient as a place of meeting for the parties in interest, the court shall fix a place for the meeting which is the most convenient for parties in interest.
>
> At the first meeting of creditors the judge or referee shall preside, and, before proceeding with the other business, may allow or disallow the claims of creditors there presented, and may publicly examine the bankrupt or cause him to be examined at the instance of any creditor.
>
> The creditors shall at each meeting take such steps as may be pertinent and necessary for the promotion of the best interests of the estate and the enforcement of this act.

The jurisdiction of the referees is defined in Chapter V, section 38, as follows:

> Referees respectively are hereby invested, subject always to a review by the judge, within the limits of their districts as established from time to time, with jurisdiction to (1) consider all petitions referred to them by the clerks and make the adjudi-

> cations or dismiss the petitions; (2) exercise the powers vested in courts of bankruptcy for the administering of oaths to and the examination of persons as witnesses and for requiring the production of documents in proceedings before them, except the power of commitment; (3) exercise the powers of the judge for the taking possession and releasing of the property of the bankrupt in the event of the issuance by the clerk of a certificate showing the absence of a judge from the judicial district, or the division of the district, or his sickness, or inability to act; (4) perform such part of the duties except as to questions arising out of the applications of bankrupts for compositions or discharges, as are by this act conferred on courts of bankruptcy and as shall be prescribed by rules or orders of the courts of bankruptcy of their respective districts, except as herein otherwise provided; and (5) upon the application of the trustee during the examination of the bankrupts, or other proceedings, authorize the employment of stenographers at the expense of the estates at a compensation not to exceed ten cents per folio for reporting and transcribing the proceedings.

The duties of the referees are prescribed in Chapter V, section 39, as follows:

> Referees shall (1) declare dividends and prepare and deliver to trustees dividend sheets showing the dividends declared and to whom payable; (2) examine all schedules of property and list of creditors filed by bankrupts and cause such as are incomplete or defective to be amended; (3) furnish such information concerning the estates in process of administration before them as may be requested by the parties in interest; (4) give notices to creditors as herein provided; (5) make up records embodying the evidence, or the substance thereof, as agreed upon by the parties in all contested matters arising before them, whenever requested to do so by either of the parties thereto, together with their findings therein, and transmit them to the judges; (6) prepare and file the schedules of property and lists of creditors required to be filed by the bankrupts, or cause the same to be done, when the bankrupts fail, refuse, or neglect to do so.

The Trustee

A trustee is the one elected by the creditors to take charge of a bankrupt estate, a majority in both number and amount

of provable claims being necessary to effect such an election. Creditors holding some security for their claims are not allowed to vote in the proceedings, so far as those claims are concerned, unless the security is insufficient to cover the entire claim. In the latter case they may vote the amount of the claim over and above the value of the security. Just as the referee represents the court, we have the trustee representing the creditors. This places the administration of a bankrupt estate entirely in the hands of the creditors, acting through the medium of their trustee. In event the creditors cannot agree on a trustee, the referee appoints one—the selection always being subject to ratification by the court.

The duties of a trustee are outlined in Chapter V, section 47, paragraph (a), as follows:

> Trustees shall respectively (1) account for and pay over to the estates under their control all interest received by them upon property of such estates; (2) collect and reduce to money the property of the estates for which they are trustees, under the direction of the court, and close up the estate as expeditiously as is compatible with the best interests of the parties in interest; and such trustees, as to all property in the custody or coming into the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a creditor holding a lien by legal or equitable proceedings thereon; and also, as to all property not in the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a judgment creditor holding an execution duly returned unsatisfied; (3) deposit all money received by them in one of the designated depositories; (4) disburse money only by check or draft on the depositories in which it has been deposited; (5) furnish such information concerning the estates of which they are trustees and their administration as may be requested by parties in interest; (6) keep regular accounts showing all amounts received and from what sources and all amounts expended and on what accounts; (7) lay before the final meeting of the creditors detailed statements of the administration of the estate; (8) make final reports and file final accounts with the courts fifteen days before the days fixed for the final meetings of the creditors; (9) pay

dividends within ten days after they are declared by the referees; . . . . money on hand, and such other details as may be required by the courts, within the first month after their appointment and every two months thereafter, unless otherwise ordered by the courts; and (11) set apart the bankrupt's exemptions and report the items and estimated value thereof to the court as soon as practicable after their appointment.

It is quite apparent what an important personage a trustee is, for upon qualifying for the position by filing a bond, the amount of which is determined by the creditors in accordance with Chapter V, section 50, paragraph (c):

> The creditors of a bankrupt estate, at their first meeting after the adjudication, or after a vacancy has occurred in the office of trustee, ... shall fix the amount of the bond of the trustee; they may at any time increase the amount of the bond. . . . .

He becomes vested with the title to all property of the bankrupt, by virtue of Chapter VII, section 70, which is as follows:

> The trustee of the estate of a bankrupt, upon his appointment and qualification, and his successor or successors, if he shall have one or more, upon his or their appointment and qualification shall in turn be vested by operation of law with the title of the bankrupt, as of the date he was adjudged a bankrupt, except in so far as it is to property which is exempt, to all (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks; (3) powers which he might have exercised for his own benefit, but not those which he might have exercised for some other person; (4) property transferred by him in fraud of his creditors; (5) property which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him: PROVIDED, That when any bankrupt shall have any insurance policy which has a cash surrender value payable to himself, his estate, or personal representatives, he may, within thirty days after the cash surrender value has been ascertained and stated to the trustee by the company issuing the same, pay or secure to the trustee the sum so ascertained and stated, and continue to hold, own, and carry such policy free from the claims of the creditors participating in the distribution of his estate under the bankruptcy proceedings, otherwise the

> policy shall pass to the trustee as assets; and (6) rights of action arising upon contracts or from the unlawful taking or detention of, or injury to, his property.
>
> All real and personal property belonging to bankrupt estates shall be appraised by three disinterested appraisers; they shall be appointed by, and report to, the court. Real and personal property shall, when practicable, be sold subject to the approval of the court; it shall not be sold otherwise than subject to the approval of the court for less than seventy-five per centum of its appraised value.
>
> The title to property of a bankrupt estate which has been sold, as herein provided, shall be conveyed to the purchaser by the trustee.

The trustee proceeds to dispose of the bankrupt estate to the greatest advantage and best interests of all the creditors. Compensation for his efforts is regulated by the law itself on a percentage basis, and is not sufficiently large to make the office very attractive. It is 6 per cent on the first $500, 4 per cent on that from $500 to $1,500, 2 per cent on that from $1,500 to $10,000, and 1 per cent on all above $10,000.

Filing of Claims

The importance of creditors filing their claims promptly upon receipt of notice of the adjudication or the first creditors' meeting is obvious when it is remembered that none but creditors with allowed claims can participate in the selection of a trustee.

There is a prescribed bankruptcy form, the "proof of debt" (Form 28a), for the use of creditors in filing their claims, so drawn as to comply with Chapter VI, section 57, paragraph (a):

> Proof of claims shall consist of a statement under oath, in writing, signed by a creditor setting forth the claim, the consideration therefor, and whether any, and, if so, what securities are held therefor, and whether any, and if so, what payments have been made thereon, and that the sum claimed is justly owing from the bankrupt to the creditor.

PROOF OF DEBT DUE CORPORATION

IN THE DISTRICT COURT OF THE UNITED STATES,

For the ..*Southern*.. District of ..*Ohio*..

....*The Union Leather Company*.. ....*Cincinnati, Ohio*.......	IN BANKRUPTCY, No. ......

At ..*Cincinnati*.., in said ..*Southern*.. district of ..*Ohio*.., on the ..*nineteenth*.. day of ..*August*.., A. D. ..*19—*.., came ..*William J. Schawe*.. of ..*Cincinnati*.., in the county of ..*Hamilton*.., and State of ..*Ohio*.., and made oath, and says that he is ..*Treasurer*..(1) of the ..*The Durrell-Schawe Manufacturing Co*.. a corporation incorporated by and under the laws of the State of ..*Ohio*.. and carrying on business at ..*Cincinnati*.., in the county of ..*Hamilton*.., and State of ..*Ohio*.., and that he is duly authorized to make this proof, and says that the said ...*The Union Leather Company*...the person by [or, against] whom a petition for adjudication of bankruptcy has been filed, was at and before the filing of said petition, and still is justly and truly indebted to said corporation in the sum of ..*Ninety-five and 46/100*.. dollars; that the consideration of said debt is as follows: ..*merchandise sold and delivered on open account by said claimant to said debtor, at its special instance and request, as per statement attached*.. that no part of said debt has been paid, except .... that there are no set-offs or counterclaims to the same, except .... and that said corporation has not, nor has any person by its order, or to the knowledge or belief of said deponent, for its use, had or received any manner of security for said debt whatever, or any note for such account; nor has any judgment been rendered thereon.(3)

.............*Wm. J. Schawe*.............

..*Treasurer*.. (1) of said Corporation.

Subscribed and sworn to before me this ..*nineteenth*.. day of ..*August*.., A. D. ..*19—*..

............*Howard D. Merry*............

..*Notary Public—Hamilton County, Ohio*..(2)

My commission expires Oct. 23, 19—

(1). This deposition must be made by the treasurer, or, if the corporation has no treasurer, by the officer whose duties most nearly correspond to those of treasurer.

(2). Signature and official character of officer. This may be acknowledged before a referee, or a United States commissioner, or a notary public.

(3). See Gen. Ord. 21.

Form 28. (a) Proof of Debt Filed in Bankruptcy Proceedings

A blank power of attorney is incorporated in the "proof of debt" (Form 28b), in event the creditor is unable to be present himself and wishes to be represented by an attorney. A general letter of attorney in fact (Form 29) may be used after a creditor has once filed his claim.

Proof of claims is denied all creditors, as a rule, after one year from the adjudication, Chapter VI, section 57, paragraph (n), providing:

> Claims shall not be proved against a bankrupt estate subsequent to one year after the adjudication; or if they are

IN THE DISTRICT COURT OF THE UNITED STATES
For the ..*Southern*.. District of ..*Ohio*..

..*The Union Leather Company*.. } IN BANKRUPTCY
.......*Cincinnati, Ohio*....... } No.

To ..*Brown, Bussey & Williams—Attorneys at Law*..
..*Cincinnati, Ohio*..

I ..*William J. Schawe*.., of ..*Cincinnati*.. in the county of ..*Hamilton*.., and State of ..*Ohio*.., do hereby authorize you, or any one of you, to attend the meeting or meetings of creditors of the bankrupt aforesaid at a court of bankruptcy, wherever advertised or directed to be holden, on the day and at the hour appointed and notified by said court in said matter, or at such other place and time as may be appointed by the court for holding such meeting or meetings, or at which such meeting or meetings, or any adjournment or adjournments thereof may be held, and then and there from time to time, and as often as there may be occasion, for me and in my name to vote for or against any proposal or resolution that may be then submitted under the acts of Congress relating to Bankruptcy; and in the choice of trustee or trustees of the estate of the said bankrupt, and for me to assent to such appointment of trustee; and with like powers to attend and vote at any other meeting or meetings of creditors, or sitting or sittings of the court, which may be held therein for any of the purposes aforesaid; also to accept any composition proposed by said bankrupt in satisfaction of his debts, and to receive payments of dividends and of money due me under any composition, and for any other purpose in my interest whatsoever, with full power of substitution.

In Witness Whereof, I have hereunto signed my name and affixed my seal the ..*19*.. day of ..*August*.. A. D. ..*19—*..

.............*Wm. J. Schawe*............

Signed, sealed and delivered in presence of
..(*signature of witness*)..

Acknowledged before me this ..*nineteenth*.. day of ..*August*.. A. D. ..19—..

...........*Howard D. Merry*...........
..*Notary Public—Hamilton County, Ohio*..(1)

My commission expires Oct. 23, 19—

The State of ..*Ohio*.., County of ..*Hamilton*.., ss:
..*William J. Schawe*.., being first duly sworn, says that he is ..*Treasurer of The Durrell-Schawe Manufacturing Co*... and that he is duly authorized to execute the foregoing power of attorney.

.............*Wm. J. Schawe*............

Sworn to and subscribed before me this ..*nineteenth*.. day of ..*August*,.. A. D. 19—..

...........*Howard D. Merry*...........
...*Notary Public—Hamilton County, Ohio*...

My commission expires Oct. 23, 19—

(1). Signature and official character of officer. This may be proved or acknowledged before a referee, or a United States Commissioner or a notary public. When executed on behalf of a partnership or of a corporation, the person executing the instrument shall make oath that he is a member of the partnership, or a duly authorized officer of the corporation on whose behalf he acts. When the person executing is not personally known to the officer taking the proof or acknowledgment, his identity shall be established by satisfactory proof.

Form 28. (b) Power of Attorney (Reverse of Proof of Debt)

General Letter of Attorney in Fact when Creditor is not Represented by Attorney at Law

In the District Court of the United States,
For the ..*Southern*.. District of ..*Ohio*..

....*The Union Leather Company*.. ....*Cincinnati, Ohio*.......	IN BANKRUPTCY, No. ......

To ..*Vaughn E. Montgomery*..
..*Cincinnati, Ohio*..

I, ..*William J. Schawe*.., of ..*Cincinnati*.. in the county of ..*Hamilton*.., and State of ..*Ohio*.., do hereby authorize you, or any one of you, to attend the meeting or meetings of creditors of the bankrupt aforesaid at a court of bankruptcy, wherever advertised or directed to be holden, on the day and at the hour appointed and notified by said court in said matter, or at such other place and time as may be appointed by the court for holding such meeting or meetings, or at which such meeting or meetings, or any adjournment or adjournments thereof may be held, and then and there from time to time, and as often as there may be occasion, for me and in my name to vote for or against any proposal or resolution that may be then submitted under the acts of Congress relating to Bankruptcy; and in the choice of trustee or trustees of the estate of the said bankrupt, and for me to assent to such appointment of trustee; and with like powers to attend and vote at any other meeting or meetings of creditors, or sitting or sittings of the court, which may be held therein for any of the purposes aforesaid; also to accept any composition proposed by said bankrupt in satisfaction of his debts, and to receive payment of dividends and of money due me under any composition, and for any other purpose in my interest whatsoever, with full power of substitution.

In witness whereof, I have hereunto signed my name and affixed my seal the ..*19th*.. day of ..*August*.., A. D. 19..—..

..........*Wm. J. Schawe*..........[Seal]

Signed, sealed, and delivered in presence of

....

Acknowledged before me this ..*19th*.. day of ..*August*.., A. D. 19—..

............*Wm. J. Schawe*............
..*Treasurer of The Durrell-Schawe Manufacturing Co.*(1)

The State of ..*Ohio*.., County of ..*Hamilton*.., ss:
..*William J. Schawe*.., being first duly sworn, says that he is ..*Treasurer of The Durrell-Schawe Manufacturing Co.*.., and that he is duly authorized to execute the foregoing power of attorney.

............*Wm. J. Schawe*............

Sworn to and subscribed before me this ..*19th*.. day of ..*August*.., A. D. 19—..

...........*Howard D. Merry*...........

My commission expires Oct. 23, 19—..
...*Notary Public—Hamilton County, Ohio*...

(1). Signature and official character of officer. This may be proved or acknowledged before a referee, or a United States Commissioner, or a notary public. When executed on behalf of a partnership or of a corporation, the person executing the instrument shall make oath that he is a member of the partnership, or a duly authorized officer of the corporation on whose behalf he acts. When the person executing is not personally known to the officer taking the proof or acknowledgment, his identity shall be established by satisfactory proof.

Form 29. General Letter of Attorney in Fact

liquidated by litigation and the final judgment therein is rendered within thirty days before or after the expiration of such time, then within sixty days after the rendition of such judgment.

Meetings of Creditors

It is generally at the first creditors' meeting and after a trustee has been selected, that the bankrupt is sworn by the court and placed on the witness stand, it being a privilege of the creditors to examine him personally or through their attorneys. Subsequent meetings may be called for conference in regard to disposition of the estate, as provided for in Chapter VI, section 55, paragraphs (e) and (f):

> The court shall call a meeting of creditors whenever one-fourth or more in number of those who have proven their claims shall file a written request to that effect; if such request is signed by a majority of such creditors, which number represents a majority in amount of such claims, and contains a request for such meeting to be held at a designated place, the court shall call such meeting at such place within thirty days after the date of the filing of the request.
>
> Whenever the affairs of the estate are ready to be closed a final meeting of creditors shall be ordered.

provided the creditors are notified as stipulated in Chapter VI, section 58, paragraphs (a) and (c):

> Creditors shall have at least ten days' notice by mail, to their respective addresses as they appear in the list of creditors of the bankrupt, or as afterwards filed with the papers in the case by the creditors, unless they waive notice in writing, of (1) all examinations of the bankrupt; (2) all hearings upon application for the confirmation of compositions; (3) all meetings of creditors; (4) all proposed sales of property; (5) the declaration and time of payment of dividends; (6) the filing of the final accounts of the trustee, and the time when and the place where they will be examined and passed upon; (7) the proposed compromise of any controversy; (8) the proposed dismissal of the proceedings; and (9) there shall be thirty days' notice of all applications for the discharge of bankrupts.
>
> All notices shall be given by the referee, unless otherwise ordered by the judge.

Examination of the Bankrupt

This is oftentimes a most important phase of the proceedings, especially when suspicion attaches to the disposition of certain property of the bankrupt, for under such circumstances it is incumbent upon the creditors to establish the fraud or preference, and it is primarily to enable and assist them in making out their case that this privilege is extended in Chapter III, section 7, paragraph (a):

> The bankrupt shall (1) attend the first meeting of his creditors if directed by the court or a judge thereof to do so, and the hearing upon his application for a discharge, if filed; (2) comply with all lawful orders of the court; (3) examine the correctness of all proofs of claims filed against his estate; (4) execute and deliver such papers as shall be ordered by the court; (5) execute to his trustee transfers of all his property in foreign countries; (6) immediately inform his trustee of any attempt, by his creditors or other persons, to evade the provisions of this act, coming to his knowledge; (7) in case of any person having to his knowledge proved a false claim against his estate, disclose that fact immediately to his trustee; (8) prepare, make oath to, and file in court within ten days, unless further time is granted, after the adjudication, if an involuntary bankrupt, and with the petition if a voluntary bankrupt, a schedule of his property, showing the amount and kind of property, the location thereof, its money value in detail, and a list of his creditors showing their residences . . . . the amounts due each of them, all in triplicate, one copy of each for the clerk, one for the referee, and one for the trustee; and (9) when present at the first meeting of his creditors, and at such other times as the court shall order, submit to an examination concerning the conducting of his business, the cause of his bankruptcy, his dealings with his creditors and other persons, the amount, kind, and whereabouts of his property, and in addition, all matters which may affect the administration and settlement of his estate; but no testimony given by him shall be offered in evidence against him in any criminal proceeding.

Upon examination, should the bankrupt prove an unsatisfactory or hostile witness by refusing to answer, produce records, or by giving evasive replies as to matters with which

he must be familiar, or in any other way manifest a disposition to withhold information which would be helpful to the trustee in tracing certain property, it is within the power of the court to confine him for contempt of court. Furthermore, he is subject to arrest in event he should refuse to appear for examination when properly summoned, and also upon satisfactory proof that he intends leaving the district to avoid examination.

While it is the privilege of any bona fide creditor personally to question the bankrupt, it has proved most satisfactory and expedient to have the examination conducted by an attorney skilled in the art and also conversant with bankruptcy proceedings.

Disposition of Assets

In winding up a bankrupt's estate, everything depends upon the trustee, and it is his duty to make a searching investigation with a view to recovering every payment made to creditors within four months prior to filing of petition and constituting a preference within the meaning of Chapter VI, section 60, paragraph (a) ·

> A person shall be deemed to have given a preference if, being insolvent, he has, within four months before the filing of the petition, or after the filing of the petition and before the adjudication, procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class. Where the preference consists in a transfer, such period of four months shall not expire until four months after the date of the recording or registering of the transfer, if by law such recording or registering is required.

In other words, the object of the Bankruptcy Act is to provide for an equitable distribution of the property owned by the bankrupt four months before the filing of the petition.

But in order to recover the amount of such payments it is

necessary to prove that the creditor receiving the payment must have had reasonable cause to believe the debtor was insolvent at the time.

Debts Having Priority

The following debts are given priority over the claims of general creditors in Chapter VII, section 64:

1. All taxes due to the United States, the state, county district, municipality, or any board having legal right to levy taxes.
2. The necessary costs of preserving the estate subsequent to filing the petition.
3. The filing fees in involuntary proceedings, and the reasonable expenses of recovering transferred and concealed assets.
4. The cost of administration and one reasonable attorney's fee for services actually rendered to the petitioning creditors in involuntary petitions, and to the bankrupt in voluntary cases if the court allows.
5. Wages to employees earned within three months prior to bankruptcy proceedings, not exceeding $300 to each claimant.

A judgment creditor has no preference over other unsecured creditors unless an execution has been levied on specific property at least four months prior to the filing of the petition.

Distribution of Assets of Bankrupt Partnerships and Partners

Under the Bankruptcy Act the assets of bankrupt partnerships and partners are to be distributed in accordance with Chapter III, section 5, paragraph (f):

> The net proceeds of the partnership property shall be appropriated to the payment of the partnership debts, and the net proceeds of the individual estate of each partner to the payment of his individual debts. Should any surplus remain of the property of any partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied

> to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be added to the assets of the individual partners in the proportion of their respective interests in the partnership.

Inconsistent as it may seem, it is entirely possible that a firm or partnership may be bankrupt and the individuals comprising it solvent. Hence, where an act of bankruptcy, in which one partner did not participate, has been committed by an insolvent firm, the partnership and the participating partner may be adjudged bankrupt in an involuntary proceeding, though the court has no jurisdiction in such proceeding so to adjudicate the non-participating member. Such a situation presents a point of particular interest to firm creditors, namely, as to the assets available for the payment of dividends.

The common law partnership principle, upon which the right of the partnership creditor to look to the estate of the individual partner is based, is that each partner is liable for the whole of the partnership debts. Under circumstances such as we are assuming, a legal fiction permits the creditors to share in the assets of the non-participating partner. This is made possible through adoption of the theory that under the Bankruptcy Act each partner occupies the position of surety for the firm, and, as on the default of a principal obligor the liability of his surety becomes absolute, a creditor is allowed to prove his claim against the estate of the surety on this absolute liability, regardless of the financial condition of the principal.[3]

Dividends

With regard to the payment of dividends to creditors, this phase of closing up the estate is fully covered in Chapter VII, sections 65 and 66:

> Dividends of an equal per centum shall be declared and paid on all allowed claims, except such as have priority or are secured.
>
> The first dividend shall be declared within thirty days

[3] See XVIII, Har. Law. Rev., 495.

> after the adjudication, if the money of the estate in excess of the amount necessary to pay the debts which have priority and such claims as have not been, but probably will be, allowed equals five per centum or more of such allowed claims. Dividends subsequent to the first shall be declared upon like terms as the first and as often as the amount shall equal ten per centum or more and upon closing the estate. Dividends may be declared oftener and in smaller proportions if the judge shall so order; PROVIDED, That the first dividend shall not include more than fifty per centum of the money of the estate in excess of the amount necessary to pay the debts which have priority and such claims as probably will be allowed: AND PROVIDED FURTHER, That the final dividend shall not be declared within three months after the first dividend shall be declared.
>
> Dividends which remain unclaimed for six months after the final dividend has been declared shall be paid by the trustee into court.
>
> Dividends remaining unclaimed for one year shall under the direction of the court be distributed to the creditors whose claims have been allowed but not paid in full, and after such claims have been paid in full the balance shall be paid to the bankrupt; PROVIDED, That in case unclaimed dividends belong to minors such minors may have one year after arriving at majority to claim such dividends.

The trustee is presumably competent to dispose of the assets to the best interests of the creditors, and once they have manifested their choice the policy of the creditors should be one of careful observance but non-interference, except in case of flagrant mismanagement, and then the matter should be taken up with the referee, for if there is some valid objection to the trustee, or the manner in which the estate is being handled, he may be removed for cause, and another trustee appointed.

Settlement by Composition

The proceedings may also be terminated by the bankrupt effecting a "composition settlement" with his creditors, which simply means that it is possible for a debtor either before or after being adjudged a bankrupt to arrange, generally by obtaining financial assistance from outside sources, a settlement

satisfactory to a majority of the creditors, in number and amount, who thereupon petition the court to allow it, and by so doing, compel the other creditors, in the absence of fraud, to be bound by it. Such a settlement is made possible and provided for in Chapter III, section 12:

> A bankrupt may offer either before or after adjudication, terms of composition to his creditors after, but not before, he has been examined in open court or at a meeting of his creditors, and has filed in court the schedule of his property and the list of his creditors required to be filed by bankrupts. In compositions before adjudication the bankrupt shall file the required schedules, and thereupon the court shall call a meeting of creditors for the allowance of claims, examination of the bankrupt, and preservation or conduct of estates, at which meeting the judge or referee shall preside; and action upon the petition for adjudication shall be delayed until it shall be determined whether such composition shall be confirmed.
>
> An application for the confirmation of a composition may be filed in the court of bankruptcy after, but not before, it has been accepted in writing by a majority in number of all creditors whose claims have been allowed, which number must represent a majority in amount of such claims, and the consideration to be paid by the bankrupt to his creditors, and the money necessary to pay all debts which have priority and the cost of the proceedings, have been deposited in such place as shall be designated by and subject to the order of the judge. . . . .
>
> The judge shall confirm a composition if satisfied that (1) it is for the best interests of the creditors; (2) the bankrupt has not been guilty of any of the acts or failed to perform any of the duties which would be a bar to his discharge; and (3) the offer and its acceptance are in good faith and have not been made or procured except as herein provided, or by any means, promises, or acts herein forbidden.

It is a fraud upon a creditor who is a party to a composition agreement for the debtor to make a secret contract with any other creditor whereby the latter is promised more than his pro rata share as an inducement for him to join in the composition. A composition agreement which provides for a pro rata payment to all of the creditors entitles each creditor to

assume that all of the creditors are to be treated alike, and hence the preference may be said to be fraudulent as to him if he was ignorant of it. The law, therefore, permits him, upon discovering the facts, to disregard the release he gave and to sue for the unpaid balance of his original claim.[4]

Chapter III, section 14, paragraph (c) provides for the discharge of the bankrupt under such circumstances:

> The confirmation of a composition shall discharge the bankrupt from his debts, other than those agreed to be paid by the terms of the composition and those not affected by a discharge.

Ordinarily, the main purpose of the bankrupt in effecting such a settlement is to regain possession of the assets with a view either to continuing in business or disposing of them at a profit as a going concern.

Any creditor who thinks that the debtor is not offering enough may offer to take over the stock himself and to pay the other creditors a higher dividend. This usually brings a higher offer from the bankrupt if he is trying to defraud his creditors. The creditor making the offer must also pay the expense of the proceedings up to the time the compromise is made.

Otherwise, when all of the assets of the bankrupt have been converted into money and the proceeds distributed among the creditors, the duties of the trustee terminate with the completion of the administration of the estate.

Discharge of Bankrupt

When the bankrupt has made an honest accounting of all his debts and belongings, and has done all in his power to facilitate the proceedings, he is entitled to a discharge. When granted, this relieves him of the legal obligation to pay in full any of the debts which were included in the proceedings, and

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[4] See Schaub and Isaacs, The Law in Business Problems, p. 432.

he cannot thereafter be proceeded against at law unless he acknowledge in writing that such debts are still due and owing.

A discharge in bankruptcy does not discharge the obligation, but it affords the bankrupt a defense to being held legally liable on the obligations listed in his schedule. In other words, the effect of the discharge is not to discharge the claim, and consequently, if a creditor should sue on his original claim after such a discharge has been granted, he could recover unless the discharge in bankruptcy is set up as a defense to the action.

Even after a discharge in bankruptcy has been granted to a bankrupt, the moral obligation to satisfy his creditors in full still persists, and when able, the bankrupt should feel in honor duty bound to pay the remaining amounts due.

Chapter III, section 14, paragraph (a) provides:

> Any person may, after the expiration of one month and within the next twelve months subsequent to being adjudged a bankrupt, file an application for a discharge in the court of bankruptcy in which the proceedings are pending.

The act also provides in paragraph (b) of the same section when a discharge shall not be granted:

> The judge shall hear the application for a discharge and such proofs and pleas as may be made in opposition thereto by the trustee or other parties in interest, at such times as will give the trustees or parties in interest a reasonable opportunity to be fully heard, and investigate the merits of the application and discharge the applicant unless he has (1) committed an offense punishable by imprisonment as herein provided; or (2) with intent to conceal his financial condition, destroyed, concealed, or failed to keep books of account or records from which such condition might be ascertained; or (3) obtained money or property on credit upon a materially false statement in writing, made by him to any person or his representative for the purpose of obtaining credit from such person; or (4) at any time subsequent to the first day of the four months immediately preceding the filing of the petition transferred, removed, destroyed, or concealed or permitted to be removed, destroyed, or concealed, any of his property, with intent to hinder, delay,

> or defraud his creditors; or (5) in voluntary proceedings been granted a discharge in bankruptcy within six years; or (6) in the course of the proceedings in bankruptcy refused to obey any lawful order of, or to answer any material question approved by the court; PROVIDED, That a trustee shall not interpose objections to a bankrupt's discharge until it shall be authorized so to do at a meeting of creditors called for that purpose.

A "saving clause" in the act, Chapter III, section 15, paragraph (a), further provides for a possible revocation of the discharge, under certain conditions:

> The judge may, upon the application of parties in interest who have not been guilty of undue laches, filed at any time within one year after a discharge shall have been granted, revoke it upon a trial if it shall be made to appear that it was obtained through the fraud of the bankrupt, and that the knowledge of the fraud has come to the petitioners since the granting of the discharge, and that the actual facts did not warrant the discharge.

In other words, if there has been any fraud in bringing the proceedings, or in concealing property which should have been surrendered for the benefit of creditors, any of the defrauded creditors may come in within a year after the discharge has been granted and have it revoked. What is oftentimes not realized until it is too late to profit by it is that "honesty is always the best policy" for an insolvent debtor to adopt in dealing with his creditors, and this is particularly true in bankruptcy proceedings.

All creditors receive 30 days' notice of all hearings upon such applications. Chapter VI, section 58, paragraph (a-9) says:

> There shall be 30 days notice of all applications for the discharge of bankrupts.

And any creditor who intends to oppose it must file with the clerk of the court a sworn statement, on a prescribed form, stating briefly his intentions and the grounds on which the discharge is to be opposed.

There is, finally, a further distinction between voluntary and involuntary bankruptcy based on Chapter III, section 14, which denies a discharge to a bankrupt who has been granted a previous discharge within the preceding 6 years. In other words, a debtor may not obtain two discharges in bankruptcy within 6 years, provided the first was voluntary. Hence the advisability of persuading an insolvent debtor to file his own petition.

Concealment of Assets in Bankruptcy Cases

Although section 29 of the Bankruptcy Act has made it a crime for a debtor to have "concealed, while a bankrupt, or after his discharge, from his trustee any of the property belonging to his estate in bankruptcy," experience has shown that this is one of the usual incidents to be expected in the ordinary dishonest bankruptcy case. Although the commercial community demands a criminal prosecution in an extraordinarily flagrant case of concealing assets, the average merchant's primary interest is merely to recover such assets as to make his dividend from the estate as large as possible. He is willing that such dishonest merchants shall be punished, but he will usually forego this desire if the bankrupt tempts him to accept a composition by giving him a few cents on the dollar more than "the assets in sight" will yield. While this may be due in part to a lax commercial standard among merchants, the principal cause of it is found in the attitude of many of the courts in demanding a standard of proof concerning concealed assets, which is commercially impracticable.

The courts have generally laid it down as a fundamental axiom in this class of cases that they will not make an order on the bankrupt to turn over to his trustee secreted assets which he is alleged to be wrongfully withholding unless they are prepared to follow up a non-compliance with such order by a further order committing him for contempt of court.[5] The

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[5] 126 Fed. 464.

result therefore is that the inquiry concerning assets wrongfully concealed by a bankrupt from his trustee naturally divides itself into two distinct lines of investigation: The first is whether any assets have been secreted by the bankrupt, and if so what they are; the second is what can be done by the creditors of the bankrupt to procure the return of the assets.

The first question is necessarily one of fact and it behooves the creditors or trustee to present such evidence to the court as would justify the inference that there has been a concealment of assets.

Returning Concealed Assets

A question which presents far greater perplexities, however, is what the court will require in the way of proof as to the bankrupt's ability to comply with an order to return assets which the court is willing to believe have been wrongfully withheld from the bankrupt's estate. On this question there is a wide divergence of legal opinion, ranging between two extreme views. The one view is:

> The rule by which this issue is to be determined is that the property of the bankrupt estate traced to the recent possession or control of the bankrupt is presumed to remain there until he satisfactorily accounts to the court for its disappearance or disposition. He cannot escape an order for its surrender by simply adding perjury to fraudulent concealment or misappropriation. It is still the duty of the referee and of the court, notwithstanding his oath and testimony, if satisfied *beyond a reasonable doubt* that he has property of the estate in his possession or under his control, to order him to surrender it to the trustee, and to enforce that order by confinement as for contempt.[6]

The opposing view holds:

> It follows unquestionably that an order imprisoning a bankrupt for contempt for failure to obey a decree to pay

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[6] 116 Fed. 131.

money or to surrender goods into court, is erroneous as a matter of law where the bankrupt by sworn answer denies that he has the money or the goods and it does not appear clearly affirmatively from the record, notwithstanding his denials, that he has the power to comply with the decree. The bankrupt is entitled to at least that much protection if indeed the courts are to refuse to follow the wise rule of the common law which makes the sworn denials of the answer sufficient defense to the contempt proceedings, leaving the question of the truth of the answer to be contested in a prosecution for perjury.[7]

Whichever of these opinions is followed, the inevitable conclusion is that no order is to be made on the bankrupt unless the court is satisfied *beyond a reasonable doubt* that the bankrupt has the secreted assets in actual possession or control. The requirement of stronger evidence than "a preponderance" in both instances is undoubtedly due to the criminal aspect of proceedings to compel a restitution of property and its legal complement of contempt proceedings for a failure to carry out such an order when issued.

This excessive caution on the part of the courts has no doubt been prompted largely by their desire to prevent a harsh or abusive use of the Bankruptcy Act by overzealous creditors against their debtors. Such a view is at least to be inferred from the remarks of the court in deciding the case of In re Davidson :[8]

Creditors who sell to persons of doubtful or unknown financial standing, and of unknown or suspicious character or integrity, and who by their own lack of ordinary diligence have become the victims of fraud, should proceed for redress under the ordinary methods of legal procedure and cannot expect to use, as an ordinary agent, in the collection of their debts, the power to imprison for contempt, which is to be applied only in cases of contumacious resistance to the orders of the court.[9]

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[7] 142 Fed. 68.
[8] 143 Fed. 173.
[9] See XXIII, Har. Law. Rev., 30.

CHAPTER XLI

THE HANDLING OF INSOLVENT ESTATES

Causes of Commercial Insolvency

In discussing the four ways in which an insolvent estate may be administered, it has very likely occurred to the reader that the basic distinction between an adjustment, or assignment, and bankruptcy is that the main object in the former is to assist the debtor in working out his difficulties and enabling him to continue in business, whereas in bankruptcy the main object is to wind up the business as soon as possible.

In this connection one must always keep in mind the fact that once a debtor is insolvent he is at the mercy of his creditors, so that it rests with them to decide whether the debtor's estate is to be handled as an adjustment or a liquidation.

The question then arises as to what determines whether an insolvent debtor is deserving of the necessary assistance of his creditors, and when is it to the best interests of all concerned to make it possible for him to continue in business. This depends primarily on the cause of the debtor's condition, as it may be due to one of the usual causes of failure or to some extraordinary cause over which the debtor has had little or no control. In other words, the causes of commercial failure may be classed as "curable" and "incurable." Conservatively speaking, however, scarcely one-fourth of the insolvencies occurring in ordinary times are due to unavoidable misfortunes, and at least three-fourths may be traced to some mental or moral shortcoming varying in degree from pitiful

incompetency to sheer deliberate roguery. For purposes of convenience these causes may be classified as:

Usual	Extraordinary
1. Indolence, neglect, or lack of initiative.	1. Sickness.
2. Unwise credits or poor collections.	2. Death of partner.
3. Overtrading on his capital.	3. Failure in some collateral investment.
4. Too heavy operating expense.	4. Liability on accommodation paper.
5. Too large drawing accounts.	5. Fire and floods.
6. Too many interested parties.	6. Unexpected failure of large customers.
	7. Embezzlement by trusted employee.

Lack of Training and Character

Another contributing and an exceedingly large cause of commercial failure is lack of training. Quite a number of the reasons customarily assigned for the failure of merchants may be grouped together under this head, and it is exceedingly significant. This lack of training is to be distinguished from lack of ability, for a merchant may have the requisite latent ability but the absence of training may render him insufficient to make a success of the enterprise in which he is engaged.

Still another contributing and important cause of commercial failure is found in lack of character. A defect in character will lead a merchant to take advantage of his creditors in a financial pinch, if he can. It may lead him to neglect the proper rules of business, to be indifferent about the keeping of proper books of account, and it may be the whisper that tells him how very easy it will be to put over a game on the credit man today, and that he might just as well profit by the ease with which credits may be obtained, as have so many others. There is probably nothing that works so surely against the success of a merchant or at the same time affords a greater menace to creditors than the lack of character.[1]

[1] Causes of Commercial Failures, published by National Association of Credit Men.

Points of Inquiry

In investigating the financial condition of a merchant, the procedure should be somewhat as follows:

1. Take the bank account and add the deposits.
2. Add the cash sales; also the collections.
3. Compare (1) with (2) to determine how much money did not go into the bank.
4. Compare deposits by months with the corresponding months of the previous year, likewise the sales, and if the sales are found to have been greater and the deposits smaller, there must be some reason for it.
5. Note if the number of checks drawn to "Cash" is unusually large, the fact that the payee is not named looks suspicious.
6. Find out if any of the receivables are pledged
7. Examine carefully the list of accounts receivable: (a) as to character of accounts, (b) time of maturity.

Any one of the first six causes of commercial insolvency may be said to constitute poor business and the presumption is therefore in favor of liquidation, whereas in the other seven the presumption is in favor of an adjustment, and an extension of a few weeks generally suffices to determine the advisability of continuing the business. If the experiment proves successful, an amicable settlement is arranged with the creditors.

Suppose some of the creditors are opposed to such a settlement and insist upon immediate payment of the entire account. If they are in the minority, a "composition before adjudication" in bankruptcy is the only means whereby a compromise settlement may be forced on such obstreperous creditors, i.e., suit is filed by three creditors to have the debtor adjudged a bankrupt, whereupon the debtor asks for a creditors' meeting in order to consider an adjustment, and the court thereupon stays proceedings until the composition settlement is confirmed. Creditors should always make it a point to insist upon the

money being put up before voting in favor of such a settlement.

Remedy Not to be Adopted

An adjustment as a continuous operation should never be permitted because:

1. If the debtor cannot operate alone at a profit, he certainly cannot with the additional expense of an adjuster or liquidator.
2. With another man running his business, and personal gain so long deferred, incentive on the part of the debtor is partly destroyed, rendering him incapable of his best efforts.
3. The compensation of an adjuster or liquidator possessing the ability necessary to manage a business, would very likely more than offset the increase in earning capacity.

The duty of the credit man in such instances is therefore not merely to give the distressed debtor temporary relief, but rather to find the cause of the failure and remove it. If the cause is such as can be remedied, the debtor may have profited by his experience and be deserving of another opportunity in business. On the other hand, if the failure smacks of fraud or dishonesty or was obviously due to incompetency, the credit man owes a duty to the business world to protect it against a recurrence of such failures, or, as it has been well put, to start such a failure in business again amounts to "turning a cripple loose upon the business world with the hope that the next time he fails he will not stick your house," and is simply another version of the "save the wolf and kill the sheep" doctrine.

Conclusion—Indices of Credit Efficiency

Whereas it devolves upon the sales department to see that all merchandise manufactured or produced is disposed of as

profitably as possible, it rests with the credit department to secure the payment of all the accounts thus created at maturity, and to see that losses from bad debts and failure to collect these outstandings are reduced to the lowest possible amount. In fact, the skill and ability of the credit man is, as a rule, judged primarily by the record of losses suffered from bad accounts.

A Fallacious Index

A small loss record alone, however, means little in judging the results or measuring the efficiency of the work of a credit department, for it is a very simple and easy task to keep the percentage of loss down to a minimum where no chances are taken. In other words, by striving for a lower loss ratio, a credit man may become ultra-conservative and thus cause loss to his firm through a decrease in the volume of business accepted, and a corresponding increase in the ratio of overhead expense.

A Proper Index

Were the required data available, a proper test whereby the skill of the credit man may be judged would consist of a comparison of the loss record with the volume of business rejected over a period of several years rather than of any one year, as follows:

	1921	1920	1919	1918
(1) Business presented..........	....	....	....	....
(2) Business accepted..........	....	....	....	....
(3) Business rejected...........	....	....	....	....
(4) Percentage of loss..........	....	....	....	....

In other words, the greater the spread between (1) and (2) the smaller should be the percentage of loss; or, to put it in another way, the more conservative the house is in extending credit, the smaller should be the percentage of loss suffered from incurring bad debts.

For the purpose of illustration, let us assume that $125,000

worth of business is submitted to the credit departments of two competitive business houses for acceptance within a given year. The first house pursues a liberal credit policy and accepts $100,000 of the business, while the other is conservative and accepts only $50,000. The result in each case may be shown as follows:

LIBERAL CREDIT POLICY

No. 1 accepts	$100,000
Manufacturer's profit (15 per cent)	1,500
Loss of 1½ per cent	1,500
Net profit	$13,500

CONSERVATIVE CREDIT POLICY

No. 2 accepts	$50,000
Manufacturer's profit (15 per cent)	7,500
Loss of 1/10 of 1 per cent	500
Net profit	$7,000

This shows that the second house has held down its percentage of loss at the expense of its business profits, thereby defeating the very purpose for which it existed.

Here then we have a sharp division of function with an ultimate unification of design—in that the salesman submits the business, and the credit man regulates the trading in such a way as to procure for the house the maximum return with a minimum of loss. It is the fact that the ultimate object of the credit man is practically the same as that of the salesman that makes it so important and vital to the best interests of the company that a close and friendly co-operative spirit should exist and be maintained between them. Moreover the moment a salesman starts "bucking" the credit department, or a credit man assumes an antagonistic attitude toward the sales force, they are defeating the very purpose for which they are employed and developing a state of affairs that will eventually militate against the best interests of either the one or the other, and possibly both.

It therefore behooves the credit man to appreciate fully his position in the service and in a pleasant but forceful manner impress upon the salesmen with whom he comes in contact, not only the prerogatives with which he is vested by virtue of his position, but also his positive duties relative to refusing business otherwise attractive. Such an understanding saves many an explanation, and, by anticipating, goes far toward overcoming in its inception the disappointment which might otherwise follow a loss of business.

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